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THE PRESIDENT'S NEW ECONOMIC PROGRAM

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HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SECOND CONGRESS

FIRST SESSION

PART 2

AUGUST 30 AND 31; SEPTEMBER 1 AND 3, 1971

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THE PRESIDENT'S NEW ECONOMIC PROGRAM

MONDAY, AUGUST 30, 1971

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire and Representative Conable.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; Richard F. Kaufman and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Bander, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will ccme to order.

Today the Joint Economic Committee resumes hearings on the President's new economic program. We shall hear this morning first from Mr. Paul W. McCracken, Chairman of the Council of Economic Advisers and Vice Chairman of the Cost of Living Council just recently established to provide the policy guidelines under which the current wage-price freeze will be operated and to develop whatever necessary programs will be needed for the period following the 3-month freeze.

We also have with us this morning General George A. Lincoln, Director of the Office of Emergency Preparedness, the office designated to administer the "freeze." We shall also hear from Mr. Arnold Weber, Executive Director of the Cost of Living Council.

We are all aware of the vast changes in economic policy which were initiated with President Nixon's speech to the Nation on Sunday, August 15—just a short 2 weeks ago. Mr. Heller, who was our first witness in this series of hearings, said that economic policy will never be quite the same. It will be dramatically changed and be pointed not only to the cutting loose from gold, which he said was a historic action which is going to change the policies dramatically, but also the fact that the President put into effect the first system of controls, although a limiting system, in relative peace time, and the first time when we had a deficit of demand in all of our history, and that from now on the big stick of direct wage-price controls will be at least a possibility, and a serious possibility, along with other methods of controlling wages and prices, such as fiscal policy and monetary policies.

Wages, salaries, rents, and prices were frozen at the levels prevailing in the month prior to the President's announcement. The dollar was freed from gold and allowed to float in international markets. A 10-percent surcharge was placed on imported goods that account for about half of the value of total imports. A program of reduced Federal taxes and expenditures was proposed, purportedly designed to stimulate economic growth and reduce unemployment.

All of the witnesses from whom we have heard thus far praised the general thrust of the President's actions although Ralph Nader was somewhat critical, more critical than others. But general agreement stopped at that point. Some noted inequities in the wage-price freeze and worried there had been no indication of concerted planning to deal with inequities which, if allowed to continue, would seriously threaten the whole program. In particular, concern was expressed about the uneven treatment of wages, interest, and profits.

There were serious questions raised as to the necessity for the import surcharge, particularly if permitted to continue for any considerable period of time.

Others questioned the adequacy of the fiscal package for promoting economic growth and getting unemployment down. Most of the experts criticized the composition of the fiscal package as heavily oriented toward business and away from the poor and the average citizen.

All of the witnesses raised serious questions as to the future—after the freeze. Some questioned whether the freeze need last as long as 3 months. There seems to be a consensus that the freeze should be replaced by a more permanent structure of controls. These are just a few of the major problems which we hope to discuss this morning.

Before we begin this morning, I would like to announce some changes in our list of witnesses for the coming week. In addition to those listed in the press releases, we are happy to have Mr. Arthur Okun appear before us on Wednesday, September 1. Mr. Okun was Chairman of the Council of Economic Advisers under former President Johnson and is now with the Brookings Institution. On Friday, September 3, we will have Robert R. Nathan, president of Robert Nathan Associates, an economic consulting firm. Mr. Nathan was Chairman of the Planning Commission of the War Planning Board in 1942–43 and in 1945 was Deputy Director for reconversion at the Office of War Mobilization and Reconversion. Alfred Tella will not appear Friday, September 3, as previously announced.

Mr. McCracken, you may proceed as you wish. The full text of your statement will be printed in the record of the hearings.

STATEMENT OF HON. PAUL W. McCRACKEN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. McCracken. Thank you very much, Mr. Chairman.

I would like to begin by outlining the general nature of this program.

As you indicated, Mr. Weber and General Lincoln are also here and they will comment on their responsibilities in this program.

"America today has the best opportunity in this century to attain two of its greatest ideals; to bring about a full generation of peace, and to create a new prosperity without war." With these words the President on August 15 proceeded to unveil what, in the quite literal

sense, must be called the most far-reaching program for economic policy during the history of this committee and the Council of Economic Advisers. Indeed, the significant feature of the program is to be found in its scope and in its integrated approach to three difficult problems that have characterized American economic developments in recent years: inflation, unemployment, and unsatisfactory developments in our external payments position.

Progress was, of course, being made on our economic problems. The economy generally was expanding. The domestic demand for output, in real terms, during 1971 rose at the rate of about 7.7 percent per year in the first quarter, followed by a 6.9 percent annual rate in the second quarter. Retail sales from January (to avoid the strike-depressed December level) to July rose at the rate of 11 percent per year, even though during half of July a substantial part of our railroad system was down from the strike. Americans have been buying automobiles at a 9–10 million rate during 1971. In July, housing starts reached their highest rate in history. Clearly the economy has been moving upward. Business has been better than sentiment about business.

There has also been progress on the price front. Thus far in 1971 the Consumer Price Index has been rising at the seasonally adjusted rate of 4 percent per year. This is well below the 6 percent figure reached at the crest in the first half of 1969, and it is less than half that which would have occurred if the post-1965 trend had continued to prevail. The private GNP deflator (to avoid the effect of Federal wage increases on the price index) in the first half of 1971 rose at the annual rate of 4.3 percent, compared with 4.9 percent in the first half of 1969. And a broadly comparable picture is evident for key components of the Wholesale Price Index in table 1.

(The table referred to follows:)

TABLE 1.—ANNUAL RATE OF RISE IN SELECTED PRICE INDEXES (SEASONALLY ADJUSTED ANNUAL RATES)

[In percent]

Period	Consumer price index	Wholesale price index			Private GNP deflator
		Total	Consumer finished goods	Producer finished goods	
1969:					
1st half	6.2	5.4	5.5	3.5	4.9
2d half	6.0	4.3	4.4	5.5	4.7
1970:					
1st half	6.0	2.2	.6	3.9	4.7
2d half	4.9	2.2	2.2	6.0	5.6
1971: 1st 7 months	3.8	4.6	2.6	3.3	[1] 4.3

[1] 1st half of 1971.

Source: Department of Labor and Department of Commerce.

Mr. McCRACKEN. Our international trade performance has been more erratic. By 1968 the surplus of merchandise exports over imports had declined to $0.8 billion from its peak in 1964 of $7.1 billion. For a Nation which should be a capital exporter, and has substantial other international obligations, this $0.8 billion clearly was an insufficiently strong external trade performance. After an improvement in 1969 and in the first half of 1970, our trade position began to deteriorate again,

and since April merchandise imports have been exceeding our exports. It is worth pointing out that the rise in our consumer price index during the last year has been less than that for the industrial world generally. Indeed, only Canada, Belgium, and Austria among the industrial nations have done better as shown in table 2. Price comparisons during the last years for manufactured goods are, however, less favorable for this country.

(The table referred to follows:)

TABLE 2.—RISE IN PRICE INDEXES DURING THE LAST 12 MONTHS FOR SELECTED COUNTRIES [1]

[In percent]

Country	Consumer Price Index	Wholesale price index for manufactured goods [2]
Austria	3.9	[3] 4.9
Belgium	4.0	(4)
Canada	2.4	2.3
France	5.0	[5] 2.3
Germany	4.9	[6] 9.2
Italy	5.2	[6] 1.2
Japan	6.6	[6] 1.0
United Kingdom	9.9	[7] 8.6
United States	4.4	3.5

[1] The 12-month period varies from country to country, depending on the latest available data.
[2] Except as noted.
[3] All items.
[4] Not available; indexes for 1970 and 1971 are not comparable.
[5] Intermediate goods.
[6] Investment goods.
[7] Excludes food.

Source: Organization for Economic Cooperation and Development.

Mr. McCracken. Progress, however, was not rapid enough on the domestic front and, as already indicated, our trade position in recent months weakened further. Economic policy, therefore, was faced with an exceedingly complex problem. Concentrating attention on any one of our problems would court the risk of aggravating the others. Severely restrictive policies would slow the domestic economy, and thereby reduce the demand for imports and perhaps reduce further the rate of inflation, but they would also tend to raise further a level of unemployment already too high. Vigorous policies to expand the demand for output would help to reduce unemployment, but they would also court the risk of impairing further an already weak external payments performance.

To break out of these dilemmas a comprehensive program of interlocking parts was required in order that we could move on all fronts simultaneously. This the President's program provides. To hasten the process of establishing the basis for a more stable level of costs and prices, the President invoked the authority given him in the Economic Stabilization Act of 1970 to impose a wage-price freeze. While the act does not extend this authority to dividends, the President in his address called on businesses to observe the terms of this freeze in dividend payments. And interest rates, also not covered in that act, are now generally at levels below those prevailing during the base period for the freeze. To administer the freeze, a Cost of Living Council was created consisting of the Secretaries of the Treasury, Agriculture, Commerce, Labor, and HUD, the Director of the Office of Man-

agement and Budget, the Chairman of the Council of Economic Advisers, the Director of the Office of Emergency Preparedness, and the Special Assistant to the President for Consumer Affairs. The Secretary of the Treasury is the Chairman of this Council, and the Chairman of the Council of Economic Advisers is Vice Chairman, and I might add also that the Chairman of the Federal Reserve Board is also an adviser and sits and meets with the Cost of Living Council.

A freeze by itself cannot be expected to do the long-run job. Indeed, by itself a freeze is apt to pile up ammunition for an explosion of wages and prices at the end. That, in fact, has tended to be international experience with freezes as such. Thus the newly created Cost of Living Council has also been directed by the President "to work with leaders of labor and businesses to set up the proper mechanism for achieving continued price and wage stability after the 90-day freeze is over." Work is now underway on a program for this postfreeze period, though it is too early to anticipate what this program will be. The objective of this program for the second phase is, however, clear enough. It is to achieve a long enough period of a reasonably stable level of prices and costs per unit of output to create a new confidence in the purchasing power of our dollars, at the same time enabling the pricing system to resume its basic function as the sensitive and sophisticated communications network for the economy.

Another set of proposals in the President's program is directed at invigorating the pace of the economy. Reductions in individual income taxes now scheduled for January 1, 1973, are to be made effective at the beginning of 1972. Elimination of the excise tax on automobiles is also proposed, and the industry has promised to pass the full amount of this reduction through the price of automobiles. A Job Development Credit is also proposed consisting of a 10-percent investment tax credit for 1 year, and dropping to a 5-percent rate thereafter. This near term will create jobs and production in a segment of the economy that has been particularly sluggish and for the longer run it will stimulate the modernization of our productive facilities so necessary to maintain our competitive position internationally and to achieve the gains in productivity out of which improvements in real wages and material levels of living are achieved.

What is a reasonable estimate about the impact of this program on the economy? This has been the subject of some discussion. Budget proposals call for reductions in outlays which, together with revenues from the new import surcharge, slightly exceed the projected reductions in other taxes. In the purely static sense such a fiscal program might be deemed to be slightly deflationary although essentially neutral. This essentially static arithmetic will not do here, however, because of the sharp incentive effects of the tax proposals. The Job Development Credit, for example, does more than leave aftertax income of the private sector some $3 billion higher.

It also increases the aftertax rate of return on investments, with a particularly large increase for projects undertaken during the year immediately ahead. Obviously the impact of the import surcharge on the domestic economy is not measured by the $2 billion estimated revenue yield. Its major impact on the economy will be the stimulus to domestic output that comes from redressing the imbalance between external and domestic price-cost levels.

Our own work indicates that for calendar year 1972 the various expenditure reductions (including reduced Federal employment) would have about a $9 billion adverse effect on GNP, and the other elements of the program would add about $24 billion to next year's GNP, with a net positive impact of $15 billion. This includes an effect of $8 billion due to a substantial shift in consumer confidence as a result of the President's program and the resulting more rapid pace of the economy.

The impact on employment of an additional $15 billion for GNP in 1972 would be substantial. If we simply divided this $15 billion by the current $13,000 of GNP per employee, the increment to employment would seem to be large indeed (well over 1 million). This, however, would overestimate the employment effect. An abnormally large part of this increased output will come through the sharp gains in productivity that should be realized as the economy's operating rate improves. Even with a generous allowance for unusually large productivity gains, however, the number of new jobs that will result from this program in 1972 will be large.

At the same time that domestic expansion and progress toward greater stability of our cost-price level needed to be accelerated, two international economic developments emerged. One was the clearly unsatisfactory trend in our own balance of payments, which by the second quarter was producing a net import surplus. And the other was evidence that our international financial system was becoming more crisis-prone. Indeed, as of August 15 currencies of countries accounting for roughly one-third of our foreign trade were already floating against the dollar.

Measures to deal with our external economic problems, therefore, had to be an integral part of the program. In his Executive order providing for stabilization of prices, rents, wages, and salaries the President noted that this action was necessary in part "to improve our competitive position in world trade and to protect the purchasing power of the dollar." Also, in his proclamation imposing a supplemental duty for balance-of-payments purposes, the President referred to the, and here I quote, "prolonged decline in the international monetary reserves of the United States and the threat to our trade and international competitive position."

The developments to which the President referred have already been indicated and are well-known to the members of this committee. Our monthly average trade surplus, which was $590 million in 1964, all but disappeared in 1968, and then after a brief recovery in late 1969 and early 1970, suffered a rapid erosion that turned it into deficits after March of this year.

The whole account of our balance of payments with foreigners has been dragged in the direction of the trade balance. Our current international account changed from a surplus of $5.8 billion in 1964 to deficits of $386 and $899 million, respectively, in 1968 and 1969, and the brief merchandise trade recovery in 1970 only supported a current account surplus of $444 million. The official reserve transactions balance of payments was in deficit by nearly $10 billion last year, and the liquidity balance deficit (excluding allocations of SDR's) was $4.7 billion. The balance-of-payments deficit on official reserve transactions skyrocketed to an annual rate of $23 billion in the second quarter.

Our net official reserve assets, in spite of being supplemented by new issues of SDR's, declined to $13.5 billion, the lowest level since World War II, and our gold stock in June was $10.5 billion. These developments clearly indicate that a serious disequilibrium had emerged in the pattern of international exchange rates, making actions to correct this imbalance necessary.

Several of the steps taken on August 15 will have effects on our trade and balance-of-payments positions. The freeze on wages and prices will prevent our competitive position in world markets from eroding further while more fundamental readjustments are brought about. The job development credit for investment in new machinery and equipment will apply only to equipment of U.S. origin and hence favor domestic suppliers. The President directed the Secretary of the Treasury to study measures for stimulating research and development of new industries and technologies. The President has also ordered a 10-percent cut in foreign aid. But the two measures in the new program that are of greatest immediate importance to our balance of payments and our international economic relations are the surcharge tax of up to 10 percent on merchandise imports and the suspension of the convertibility of the dollar into gold.

In conclusion, a few comments on systemic matters may be in order here. Our international financial system had become more crisis-prone. At the same time it has served the world economy well during the quarter of a century since World War II. The remarkable thing is not that it has developed some problems but that this system, developed at Bretton Woods in the closing days of the war and against the backdrop of great disorders in the international economy during the prewar decade, has endured so well. What we must do now is to correct the imbalances that have developed and to build more capability for flexibility and adjustment into a system which is fundamentally sound and useful. All nations have a stake in achieving those modifications in this system which will make possible another outward-looking quarter of a century of expanding international trade and vigorous economic progress.

Thank you very much, Mr. Chairman.

Chairman PROXMIRE. Thank you very much Mr. McCracken. General Lincoln, will you go ahead with your statement.

STATEMENT OF GEN. GEORGE A. LINCOLN, DIRECTOR, OFFICE OF EMERGENCY PREPAREDNESS

General LINCOLN. Mr. Chairman, and gentlemen, while I am a member of the Cost of Living Council, my great responsibility, of course, is the operations delegated to me by the chairman of the Cost of Living Council, Secretary Connally. These include responsibilities and authority to implement, administer, monitor, and enforce the stabilization of prices, rents, wages and salaries. What these words mean to us in the President's Office of Emergency Preparedness is information to the people, replies to questions, an impetus system for getting the needed policy formulated by the Council, an exemption system, a compliance system, and a reports and analysis system to gage and help gage the progress of the 90-day program. I want to make clear we can only do a part of this, and to help with planning the freeze.

With your permission, I will go over some of the functional aspects involved in the management of the freeze. First, of course, is policy formulation and to shortcut this I put these items on charts in my prepared statement and, with your permission, may I point to the first chart which has on it the major functions that I consider my office is involved in; certainly, not necessarily doing all or any one of them or the major part; for instance, policy formulation, which is the business of the Cost of Living Council. We are very much in the business of identifying areas where we need policy and pushing the question up for an answer.

As part of the procedure for doing this, an executive group of the council does meet every morning to go over questions that have been developed in the previous 24 hours, and to develop guidance which we get out to the field and to the agencies within another 24 hours.

I should note that the public questions which we receive from the field and also from Washington are very helpful in identifying the policy areas which need clarification.

Now, the daily decisions of the Cost of Living Council have come out thus far in the form of questions and answers which are published and widely disseminated through the press, to which we owe a particular note of gratitude, and through an organization which is shown schematically on the first chart in my prepared statement. In fact we had to expand from one information center in my office on Monday morning to 10 by the next Wednesday morning. Now we are in business, thanks to the Secretary of Treasury, with his Internal Revenue Service offices, and the Secretary of Agriculture, with the stabilization and conservation offices with well over 3,000 information outlets.

The Council has also sent 10 million copies of an 8-page booklet on questions and answers which deals with the most typical and frequent queries, to these field units and to more than 32,000 post offices.

But from the public standpoint we thought that it was very important that the public have a convenient place to address their questions and also to report alleged violations in person, by telephone or in writing. The 3,200 Internal Revenue Service offices and Agricultural Stabilization Conservation offices give us this capability.

All of these agencies have been asked, all other agencies have been asked, to assist in answering or referring the questions to their "clientele."

My office is moving now very rapidly to providing guidance to these other Federal offices rather than being in the question and answer business directly.

I should comment that a quick check of my new correspondence section shows that, from letters coming in, by the end of the day we will reply from Washington alone to more than 2,000 letters, and they feel that they are able to answer 10 out of 11 queries. That 11th one, by the way, is oftentimes a very sticky one and one which would take staff work and which go clear to the Cost of Living Council for a determination on policy.

Compliance problems as they arise will be handled largely through the trained investigative officers of the Internal Revenue Service to whom complaints are referred, and they take them up in a quiet, kindly and efficient manner.

If investigation develops to a point where action is required, the U.S. attorneys, which I now have on my staff in every regional office, come in to take over the job.

Chairman PROXMIRE. Take over the what, sir?

General LINCOLN. Take over the investigation at the point where legal action may be required.

Finally, of course, the Cost of Living Council is involved in analysis and evaluation, and my staff has to make a contribution to this.

I should comment that before the freeze, my office, and you might move to the next chart in my prepared statement, had eight regions being organized with civil defense and Army areas, they were coterminous with the 10-region structure. Because of our wartime responsibilities, we were in locations rather remote from the large cities, and relatively, and I underline "relatively", safe from nuclear attack, but not from a price freeze. On Sunday night, August 15, at 9:30, I ordered our Regional Directors to move to the headquarters cities for the Federal regions, and sent OEP headquarters officials to set up offices for two more new regions. In fact some of them were in business by Monday afternoon, by Wednesday afternoon all were operational. The chart shows the regional organization. We expanded from a total staff of some 300 to a present complement of about 700 by borrowing from other Federal agencies on 90-day detail. We owe an expression of deep gratitude to these Federal agencies who provided their professional people, and often their best people, without a murmur. We couldn't have done this successfully if we had not known by name or by specification the sort of people we need and if the Federal agencies hadn't been willing to let them go. We had extraordinary cooperation from the General Services Administration and from the Civil Service Commission.

Now, there, in quick outline, are the nuts and bolts of the administration that we have underway.

I need to say at the end, because I get asked this quite often by the press, we are continuing to carry out on a skeleton basis our normal responsibilities, and in certain cases we have kept the staff for particular programs, one of these programs being the national disaster assistance program. If we have a hurricane or earthquake we are set to go.

(The prepared statement of General Lincoln follows:)

PREPARED STATEMENT OF GEN. GEORGE A. LINCOLN

The operations delegated to me by the Chairman of the Cost of Living Council, Secretary Connally, include responsibility and authority to implement, administer, monitor, and enforce the stabilization of prices, rents, wages, and salaries.

What those words mean to us in the President's Office of Emergency Preparedness is information to the people, replies to questions, an impetus system for getting the needed policy formulated by the Council, an exemption system, a compliance system, and a reports and analysis system to gage the progress of the 90-day program and to help with planning for Stage 2 after the 90-day freeze.

Now, let's go over some of the functional aspects involved in the management of the freeze. First, policy formulation. Daily, my office and other agencies develop policy questions and issues which require decisions. Daily, a small policy group, of which I am a member, meets in the morning to insure that these issues are properly formulated and to suggest answers to the policy questions for consideration that afternoon by the Cost of Living Council.

I might note here that the public questions we receive from our Regions and also in Washington via Congressional offices are very helpful in identifying policy areas which need clarification.

The daily decisions of the Cost of Living Council have come out thus far in the form of questions and answers which are published and are widely disseminated through our 10 Regional Service Centers, 360 offices of the Internal Revenue Service and 2,819 local offices of the Agricultural Stabilization and

Conservation Service (see chart). The Council has also sent 10 million copies of an eight page booklet: "The Wage-Price Freeze: Questions and Answers," which covers some of the most typical and frequent queries, to these field units and to more than 32,000 post offices.

From the public's standpoint, what is more important is that they have a convenient place to which to address their questions or report alleged violations—in person, by phone or in writing. The 3,200 IRS and ASCS offices give us this capability. And all other agencies with field establishments have been asked to assist in answering or referring questions of their "clientele." OEP is providing guidance to all of them.

Monitoring and reporting functions are also accomplished through this network of IRS and ASCS offices to OEP and the Cost of Living Council.

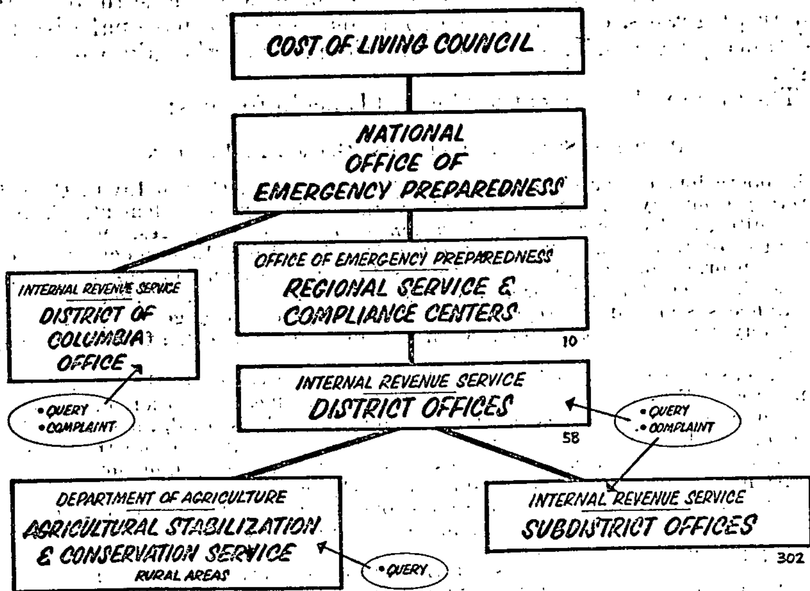
Compliance problems, as they arise, will be handled largely through the trained investigative officers of the Internal Revenue Service and U.S. attorneys working with our Regional Offices.

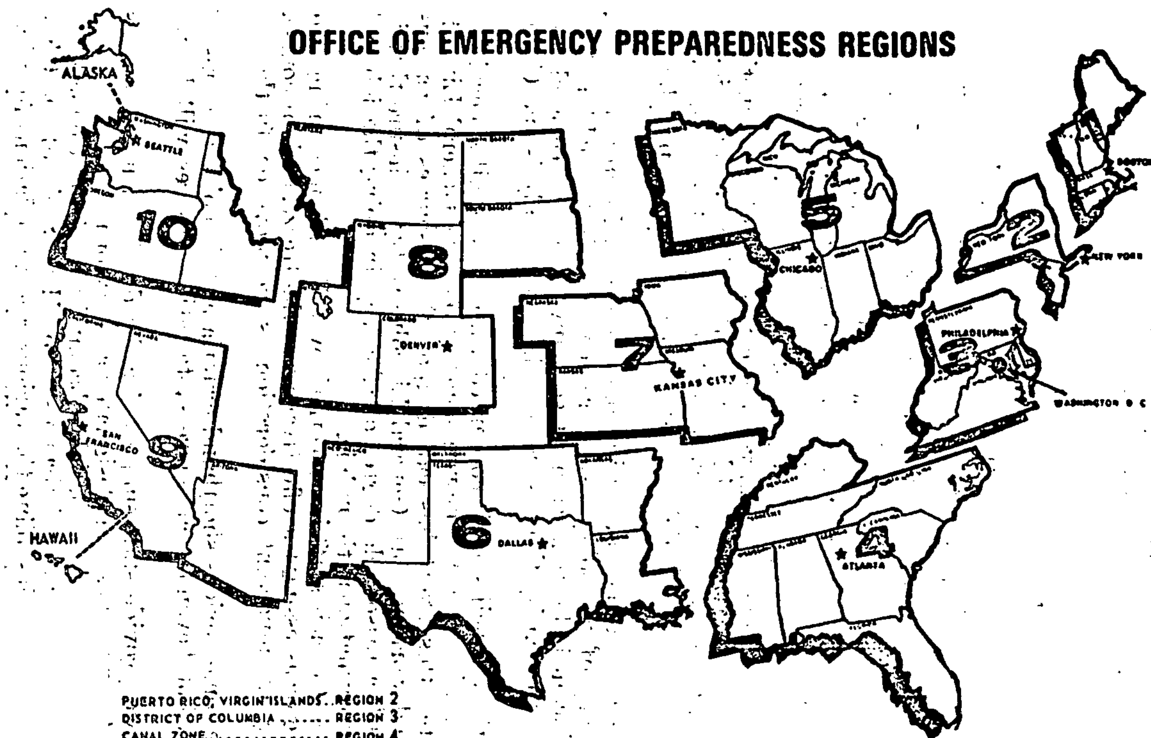
Finally, both the Cost of Living Council staff and my national headquarters are involved in analysis and evaluation of the freeze and in looking ahead to what lies beyond the 90 days.

Before the freeze, OEP had eight Regions coterminous with the 10-region structure of several other major agencies. But, with one exception, our Regional offices were not in major cities. Because of our wartime responsibilities, we were in locations relatively remote from the big cities. Sunday night, August 15, at 9:30, I ordered our Regional Directors to move to the headquarters cities for the Federal Regions, and sent OEP headquarters officials to set up offices for two more new Regions. By Wednesday, August 19, we were operational in all 10 cities: Boston, New York, Philadelphia, Atlanta, Chicago, Dallas, Kansas City, Denver (the one office we did not have to move), San Francisco, and Seattle. These are the OEP Regional Service and Compliance Centers (see map).

Our "instant" though temporary expansion has been from a total staff of some 300 to a present complement of about 700, mostly borrowed from other Federal agencies on 90-day detail. This was achieved largely through the extraordinary cooperation of the General Services Administration in finding space and equipment for our regional offices, and the Civil Service Commission in finding other Federal personnel to use those facilities. Some of these people are experts on specific areas; others are information officers and clerical staff.

Meanwhile, OEP is continuing to carry out its normal responsibilities, including the Natural Disaster Assistance Program.





August 18, 1971

Chairman PROXMIRE. Thank you, General Lincoln.
Mr. Weber, do you have a prepared statement?

STATEMENT OF HON. ARNOLD R. WEBER, EXECUTIVE DIRECTOR, COST OF LIVING COUNCIL

Mr. WEBER. I do not have a prepared statement, Mr. Chairman, but I would like to make a few comments concerning the role and functions of the staff of the Cost of Living Council.

As you know, the Cost of Living Council was set up by Executive order on August 16. The staff itself has general responsibility for providing support to the Council and a link between the Council as an entity and the various operating units, particularly OEP, and beyond that the Internal Revenue Service, components of the Department of Agriculture, and the Department of Justice.

We view our role as essentially being comprised of five functions. First, the staff is concerned with the identification of policy issues, the analysis of such issues, and the submission of policy recommendations to the Council, which are subsequently acted upon by the Council.

In this regard we try to exercise some foresight. In large measure, however, many of the policy issues are generated in the field and, as General Lincoln indicated, we meet so many times—it seems almost continuous—to identify those issues which require analysis and Council action.

Second, the Council staff is concerned with the overall supervision of what you might call the management system. As General Lincoln has indicated this effort has called upon the resources of various agencies, and working with General Lincoln we try to insure that it operates with a reasonable degree of efficiency in doing the job and providing information to the public.

Third, the Council staff is concerned overall with measuring and determining or assessing the effectiveness of the freeze, and, of course, this will be an important consideration as we move on further in time.

We have some obvious shorthand criteria at this point in terms of complaints, but beyond that, more systematic measures will be required.

Fourth, we provide staff support for the development of options with respect to what has been designated as stage or phase II.

As has been reported, a special subcommittee of the Council has been established under the chairmanship of Herb Stein of the CEA which is concerned with staffing the various recommendations for what comes after the 90-day freeze. We will provide staff support in that area.

And, last, we try to insure the dissemination of information with respect to policy guidance which has been handed down or determined by the Council, and in making sure it gets out to the people and the Nation at large.

At this point, our staff is comprised of 34 people. We expect that the staff will continue to be small and probably will not exceed 50 to 55 people.

As General Lincoln indicated, most of our staff people are on detail and I would classify myself at this point as being on detail from my family in Chicago. That completes my statement, Mr. Chairman. I will be glad to help Mr. McCracken answer any questions.

Chairman PROXMIRE. Well, Mr. McCracken and gentlemen, I want to thank you very, very much for coming up this morning. We are really indebted to you. I think it is a fine indication of the administration's determination to cooperate with Congress and to cooperate promptly.

This freeze has been in effect for 2 weeks and I think your appearance this morning is very, very encouraging and we are most grateful for it.

Mr. McCracken, this policy has been characterized by one critic as ad hocism run riot, as a complete departure from any kind of principles which the administration seemed to hold in the economic area. One basis for this kind of an argument is a quotation from what you have allegedly said in July when you said, and I quote:

> General price and wage controls would be a serious threat to individual freedom. The idea of a freeze is illusory. Wages and prices would be in upward motion on the first day. Wage-price controls threaten to speed up inflation on the demand side.

Now in view of the fact that this was your conviction a month ago, how do you justify this remarkable turnabout in such a short time?

Mr. MCCRACKEN. Let me comment on the two aspects of your question. First of all, I think most economists would share the view that permanent controls over wages and prices to the point where they seriously inhibit the operation of the pricing system would not be good, and moreover a wage-price freeze by itself is certainly no answer to the kind of problems which the American economy was facing in the summer of 1971.

Now what were these problems? This gets us to the more fundamental issue which you raised in your question. It seems to me if one looks at these problems that, far from being ad hocism, this is a remarkably interrelated or interlocked set of economic proposals to deal with what were extremely complex and, to some extent, even contradictory problems.

Chairman PROXMIRE. Can I interrupt at that point? I agree that this is a coordinated, integrated proposal and it all ties together and makes some sense from the standpoint particularly of starting off with the difficulty with the dollar, and from that you have to take certain steps with respect to domestic inflation, and so forth.

But what concerns me is the persistent expression on the part of the President of the United States, the Secretary of the Treasury, the Chairman of Council of Economic Advisers that controls were something that would not be resorted to, that a freeze was something that would not be used and would not be useful, and now you have this sudden change, something that some of us called for and that I applaud, I think it was a fine action by the President. But again I would like to have you explain how you justify that in view of your opposition to that position and that principle so firmly and so recently?

Mr. MCCRACKEN. If any kind of direct action in the wage and price area is going to be a part of the program, obviously until these are go-

ing to be announced, the position of the Government has to be what it was before. It is going to be opposed to wage and price controls and a freeze.

To discuss these in terms that it may be necessary shortly to have a wage-price freeze or something like this would have been to aggrevate the very problem that we had. This is why a Government until it makes its decision to change an exchange rate will always take the firm position that the exchange rate is solid.

But I would like to emphasize once again that we confronted here three very difficult and complex problems. One of them was the international problem. As the Secretary of the Treasury has indicated, it can certainly be considered as sort of a proximate cause or proximate explanation for the timing. Once action had to be taken it had to be a broad spectrum of action. It had to try to handle all three of them, and in the total mosaic of policies for these problems, this seemed to make sense.

Chairman PROXMIRE. Well, now, let me try it just once more because I am not sure that you understood the thrust of my question.

I am not arguing that you would have had to suggest or imply that a freeze was coming up or that you might move into some kind of wage-price controls or anything of the kind. But I am saying that within days, within almost hours, from the time the President made the announcement the administration was, firmly and emphatically saying it would not do this, it went out of its way to make its opposition clear. The President in a press conference on August 4, the Secretary of the Treasury 2 or 3 days later listed the things he would not do, and these were among them, and now the administration has done it.

Was the international situation with respect to the dollar sufficiently sudden and sharp and dangerous so that steps of this kind had to be taken?

Was this something that had developed within a matter of a week or less than a week?

Mr. McCRACKEN. Let me try once more. I think it is quite clear that the international problem was developing to the point where some kind of decisive action had to be taken. This is what I would interpret the Secretary's comment to mean when he said that the international problem was the proximate cause of movement at that time. On the other hand, the actions that had to be taken could not be simply actions in the narrow sense to deal with the international financial developments. It made sense to have actions which would cover the entire spectrum. This was the program that was worked out. I believe that at the hearings in July I used the phrase repeatedly that developments would have to be observed carefully, monitored carefully, as we go along. We had reached the point where some action had to be taken and it had to be across the board.

Chairman PROXMIRE. Now, I take it from your statement, and let me just read this one sentence:

> The purpose of this freeze, I take it, is to achieve a long enough period of a reasonably stable level of prices and costs per unit of output to create a new confidence in the purchasing power of our dollars at the same time enabling the pricing system to resume its basic functions as the sensitive and sophisticated communications network for the economy.

Does this mean that the freeze is likely to be the one time when you have a comprehensive—an effort to comprehensively limit prices and wages, and that phase 2 would be a period of relaxation, phase 2 would be a period in which you would designate substantial areas, most areas, which would be free of controls, and gradually move in as rapidly as possible to a period, to a time, with no controls at all?

Mr. McCRACKEN. It would be too early now to try to prejudge what the nature of the phase 2 program would be. We are in the early stages now of trying to work this out. At the same time the presumption would be that it would be something less severe than the kind of freeze we have at the present time. As I indicated in my statement in a sentence I read——

Chairman PROXMIRE. When you say "less severe" you are talking perhaps about wages being allowed to increase, some prices not being controlled?

Mr. McCRACKEN. I don't know that I would want to start down any list as to what it would mean for any specific item but ultimately we are going to have to move into a situation in which the pricing system can start to play its function once again. A dynamic and fast moving economy such as ours simply can't function over an extended period of time with its entire pricing system frozen.

Chairman PROXMIRE. When you say less severe does this mean that you would not move into new areas?

It is my understanding that at least two cabinet officers suggested over the weekend that the administration might consider the possibility of a limitation on profits and interest, that this was not out of the question, that they might move in that direction. Would you think that this is a possibility subsequently in the phase 2?

Mr. McCRACKEN. When I used the words "less severe," I meant in the sense of a freeze which almost says to all prices, at least in terms of ceilings, to "stand where you are." This is not the kind of thing which an economy such as ours can tolerate over a very long period.

As to what the scope may be or what changes in the scope may be in phase 2, these are matters that are under intensive review at the present time. It is my judgment that the phase 2 program will have to be something with some clout. At the same time, we will have to find that intermediate ground where this is possible but where the pricing system can still move.

Chairman PROXMIRE. How about whether or not you are considering a limitation on profits? Are you considering a limitation on profits?

Mr. McCRACKEN. I would not rule out consideration of any matter relevant to this problem.

Chairman PROXMIRE. Would you say you would not rule out some kind of control on profits, interest, and dividends?

Mr. McCRACKEN. It is simply not possible at this early stage to be more specific than to say that this whole area is under intensive review and that the program is now being developed by the Cost of Living Council, and I think it would not be appropriate for me to indicate what specific items are being considered.

Chairman PROXMIRE. At any rate, you would not deny [Laughter]; namely, the possibility that there may be a control of profits?

Mr. McCRACKEN. I would neither affirm nor deny. [Laughter.]

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman.

Mr. McCracken, I understand when you are dealing with a free market economy why you could not telegraph your punch, and I understand the same reason that you can't have a hiatus following a freeze of this sort. There will be a natural tendency for various elements of the economy to step in and try to take what they can when the getting is good, particularly if they feel the underlying causes of inflation have not been removed. From this I see you come to the conclusion that something must follow the freeze.

Mr. Weber talked about his staff being kind of a movable feast. It sounds like you are talking about some kind of a movable frost here, and I am wondering whether, regardless of whether they are being considered or not, if you might discuss the sort of options that are open following the freeze, such things as guidelines.

I am one of those who has some severe misgivings that we are walking down a primrose path here toward controls, and there may not be much alternative, particularly if we have failed to deal with the underlying problems. I want to be assured it is not an irreversible course we are following, and I want to be sure that some elements of economic freedom are going to survive in this economy of ours.

In that context, could you tell me some of the options that could be accepted regardless of whether they are under consideration, understanding again you do not wish to telegraph too far in advance the sort of result that might obtain when the time comes to move the frost a little?

Mr. McCRACKEN. The spectrum here for possibilities, of course, would extend all the way from absolutely no action at one end to a continuation of the freeze at the other. But that establishes the outer limits so far out, that that is not really responsive to your question.

There are several observations that I would make here. Whatever it is obviously will have to have pretty broad-based support from all elements of our society, because we have a fundamentally free economy, we want to continue it, and this kind of program is going to rely heavily on the common consent of the interested parties.

What are the possibilities? It might be possible to have some kind of purely arm's-length type of wage-price review board with representatives of the various interest groups in our society—agriculture, labor, business, and so forth. This has been proposed.

Another possibility was indicated by Mr. Woodcock yesterday on the television program, one which the UAW has proposed for several years. Some entity might be given legal authority to conduct hearings, after which the price and wage decisions would be made freely.

I think one moves from there in successive stages as to the kind of clout that could be employed. These raise extremely complex questions, not only in terms of their effectiveness but, as you indicated, in terms of their longer run implications. They will have to be examined very carefully, and that is the purpose of this study now.

Arnie, do you want to add anything?

Mr. WEBER. No.

Representative CONABLE. I assume you have made some projections at this point of the probable impact of this freeze, where we will be 3 months from now? What do you expect the statistics to show at that time? What kind of a statistical context are we going to be mak-

ing this later decision in? Do you expect some upward movement of the cost of living? I assume you do because it is assumed that the freeze cannot be completely effective since its effectiveness is going to be limited primarily to the areas of big labor and big industry which are easily within public scrutiny and would not be dependent on the establishment of a large bureaucracy for enforcement purposes.

Mr. McCRACKEN. It would not be realistic to expect a flat trend in the price level during this period, for two or three reasons. There is, first of all, the purely technical fact that for the next month or so some of the prices which will be going into our price indexes will constitute readings that took place before the freeze. That is particularly true of our wholesale price index.

Moreover, there is a coverage problem. Raw agricultural products, as was true during the Korean conflict, are excluded from the freeze. I would expect that that is going to make a difference. We are getting down to where we are trying to estimate statistically a differential in terms of a few tenths of a percent, and I would not have a precise figure. It is going to make a difference, but it would not be reasonable to expect a flat trend here.

Representative CONABLE. This is going to have some impact on congressional action also, of course, depending on what kind of statistics we are dealing with after the next 3-month period. You have spoken of this as a comprehensive interlocking program, and I am sure you are aware of the peril that some aspects of this program may not be acted on appropriately by the Congress. Where do you see the major items of peril in congressional action? What can louse up this program most seriously because of a failure on Congress' part or because of an exaggeration of proposals that have been made? I know some people are talking about actually increasing the tax cuts, thus moving into an even more stimulative posture than the President has already recommended. Where generally do you see the points of peril in general of congressional action here?

Mr. McCRACKEN. I have, of course, great confidence in the Congress, and I am confident that the package, broadly speaking, will be implemented. I think you identified just now one of the things we will have to watch out for. One of the great problems of economic policy is the tendency to overshoot in any period of time. This is very clear in our history. While we are currently concerned about expanding the economy, we do want to be cautious so that we don't move too far in the direction of an expansionist fiscal policy, particularly since fiscal policy is so hard to turn around, and find later on that we overdid it. The program which is put forward is appropriately stimulative, but we do have to recognize the danger of going too far.

In the international area it is very important for us to come out of this with a fundamentally outward looking world economy and an international system that will continue to expand as it did through the first quarter of the century after the war. Here is another area that I think we will have to watch.

Chairman PROXMIRE. Mr. McCracken, on that last point—I want to come back later to something else—where you say that fiscal policy is so hard to turn around, if Congress adopts a more stimulative policy, this committee recommended a whole series of proposals which would expire after a year or two. We did it for that purpose because we are

concerned about the situation 2 or 3 years down the road. The administration departed from these recommendations, suggesting that an investment credit, half of which would be permanent, for example, some of the other parts of the program that are stimulative might have a more permanent effect. Our postponement of the social security tax increase from January 1 for a year would have a profound effect but for one year. Our step-up of income tax cuts, not just 1 year but taking 1972 and 1973 into 1971 would expire, would have an impetus now when we need it, when we have 5½ million people out of work, would expire after awhile, would be phased out. Our proposals that you provide to the cities and localities a payment to compensate for their shortfall in revenue during a recession period, when you have high unemployment, that expenditure would go down as you reach 4.5 percent, that would phase out. Why wouldn't programs of this kind adopted by Congress instead of the administration's more permanent programs be wiser in giving us a stimulus now and no long-run inflationary effect?

Mr. McCRACKEN. Two comments on that: First, many of the items which the Joint Economic Committee proposed do avoid the kind of permanent problem which would exist if, for example, there would be a permanent step-up in spending on some program.

On the other hand, if action were taken now to bring forward the already scheduled reductions to January 1971, the major effect of this would start to hit the economy (allowing for the normal lag) about the middle of next year. One can see that we could get an excessive head of steam by then in the economy.

On the permanent aspect, the investment tax credit is an area where we do need to give some real thought on a continuing basis. The capital outlay area is weak. We do need to strengthen the technological and competitive base of American industry, and these items are directed at those things which will create more jobs and employment in the capital goods industries, and over the long run, improve the productivity out of which increases in real wages have to come.

Chairman PROXMIRE. Well, on this investment credit it comes on top of the accelerated depreciation guidelines which the administration announced last January, and it is a kind of double benefit to business. It adds up, according to some of the witnesses we have had testify before us, to a very, very substantial multibillion dollar advantage for business, and most of the witnesses have argued that you don't need both. If you have the accelerated depreciation you shouldn't also have the investment credit.

Is the administration contemplating the possibility of phasing out the accelerated depreciation in exchange for the investment credit or do you think the situation for investment in business is so weak that you have to have both?

Mr. McCRACKEN. The permanent program of a 5-percent investment tax credit and accelerated depreciation would be roughly what we did with the old investment tax credit; I think it might be about 1 percentage point more. The kicker in this, that is having it 10 percent for the first year, is to try to activate a little more production and activity in a segment of the economy that is particularly weak.

I would like to make one other comment here. I don't think it really quite puts the issue, to talk about an investment tax credit, for example, as being simply for business in some sense as in contrast to

employees. This is good for employees in the capital goods industry. It is good for the American economy generally because this is directed at improving productivity, which is important both in terms of price-cost stability and of improving real wages. People generally are going to be the beneficiaries of this.

Chairman PROXMIRE. I think there is a great deal to that. But isn't it also true that the accelerated depreciation guidelines are less stimulative, at least that was the conclusion of most of the economists who appeared, for each dollar loss to the Treasury, and, therefore, that part of it would be more beneficial to the stockholders and the corporations than it would be to working people who would be interested in more jobs, whereas the investment credit would be more stimulative and might be a more desirable alternative to the extent that you have one.

I take it from your reply that it would be possible to have a permanent 10 percent investment tax credit perhaps instead of the accelerated depreciation and the 5 percent investment credit. Is that a possibility?

Mr. MCCRACKEN. The point of my comment was that the 5 percent permanent investment tax credit and the accelerated depreciation would, I think, in the aggregate, be about the same as a 7-percent investment tax credit. I want to check the arithmetic on that, but I think it is about right.

Chairman PROXMIRE. You point out in your statement something that I had missed and I think most of us have missed in the past, that the so-called job development credit or investment credit for investment in new machinery and equipment will apply only to equipment of U.S. origin and hence favor domestic suppliers. I am told by my staff—they have quickly checked it—that the old investment credit applied to equipment bought abroad as well as equipment bought in this country. If this is the case, this is a departure. This means in addition to devaluing the dollar, in addition to the 10-percent surtax, a further more or less protectionist proposal. In other words, you apply the investment tax credit for the first time Americans bought equipment. Do we need that kind of intensive concentration on our own purchasing domestically, and isn't this likely to invite retaliation when coupled with all these other moves?

Mr. MCCRACKEN. I would not think that that aspect of it would be enough to invite retaliation. We are trying to stimulate the capital goods area, and if we are going to do this by tax incentives, it would seem reasonable to apply those to domestically produced output.

Chairman PROXMIRE. Do you envision the 10-percent tax on imports as a strictly temporary measure that would be phased out after negotiations, or do you think that might be a more permanent action?

Mr. MCCRACKEN. No; I would think that would be a part of the negotiations that would look toward stabilizing the new international system.

Chairman PROXMIRE. And would be dropped within a matter of months you would expect; is that right?

Mr. MCCRACKEN. I wouldn't want to put a timetable on it, but I would expect it not to be a part of the permanent scene. The President called it a temporary measure.

Chairman PROXMIRE. It might go on for as much as a year or more?

Mr. MCCRACKEN. I wouldn't want to specify; I wouldn't want to guess about that.

Chairman PROXMIRE. Your colleague on the Council of Economic Advisers, Mr. Stein, says that the one course the administration would most devoutly hope to avoid in phase 2 of the wage-price stabilization, would be general wage and price controls. He would hope it would be a transition on the way to a free market. That means adopting guidelines, invoking cooperation. Is this pretty much the way you see it, that the second phase would be a matter of adopting guidelines that would apply to large firms and large labor unions, and secure cooperation from labor and from business to abide by these guidelines?

Mr. MCCRACKEN. Yes. What we want in phase 2 is something which will essentially let our pricing system operate but, on the other hand, will have enough punch and crunch to exert a real deterrent on this sort of perpetual motion type of inflation that we have had in the last 2 years. Now, it would be important to avoid any kind of permanent wage and price controls of the comprehensive type that we have had before, and we have the problem of trying to find this somewhat indistinct path between that and something which would have no effect at all.

Chairman PROXMIRE. I take it that what the Cost of Living Council is doing, the administration is doing, is keeping your options as open as you can, trying to have as much freedom as possible, but being sure that it must work; is that right? In other words, if you have to go to extended controls, you have to move into certain areas to keep inflation under control, you will do it; is that the determination?

Mr. MCCRACKEN. The determination to deal with the inflation problem is a fixed item; I think you put it very well. It is important at this stage to keep our options open but, at the same time, be firmly determined to deal with this problem of inflation.

Chairman PROXMIRE. So you wouldn't, you have not so far, you would not permit any dogmatic feeling about principles of free market prevent you from using controls if you have to, but you hope you won't have to; is that right?

Mr. MCCRACKEN. I certainly have not considered myself a dogmatist.

Chairman PROXMIRE. Before I yield again to Congressman Conable, let me ask you about this. You say in your statement that "Even with a generous allowance for unusually large productivity gains, however, the number of new jobs that will result from this program in 1972 will be large."

Now, Mr. McCracken, you are tremendously skilled in not giving a precise answer, and I would hope in this case—I don't see that it would do any damage to anything or anybody—if you could give us some estimate of whether this is 500,000 new jobs or what you envision in terms of its effect on employment and unemployment.

Mr. MCCRACKEN. If I had to pick a figure. I would pick a figure of about a half million jobs. You will notice that that is substantially smaller than just the simple arithmetic suggesting about a million. On the other hand, as I indicated, we ought to get abnormally large gains in productivity, and my own guess would be that something in the neighborhood of a half million jobs is a reasonable estimate.

Chairman PROXMIRE. Then $8 billion is based on your estimate of the psychological effect of the President's program; is that right?

Mr. McCRACKEN. It is based on the presumption that as the pace of the economy quickens and as there is more confidence in the price level, the consumer savings rate will return to a more normal zone.

Representative CONABLE. That would have to be a drop of from 7.5 percent down to 7 or 6.5 percent, something of that kind?

Mr. McCRACKEN. Yes; a half to 1 percentage point.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Mr. McCracken, let's talk about the economic statistics at the time the freeze was imposed. I would like to know exactly where we stood at that point. First of all, was there any real significance in the fall of retail sales in July? Was that the result of the rail strike?

Mr. McCRACKEN. I would not, myself, attach any significance to that. Retail sales bounce around a great deal, and we do need to remember that the railroad strike came in July. The preliminary evidence would suggest that probably retail sales may have strengthened a bit in August.

Representative CONABLE. Is it true that inventories were rising some here at the outset of the third quarter?

Mr. McCRACKEN. Inventories generally have been rising. Business is still very cautious about adding inventories. Inventories in July for manufacturing declined a bit.

Representative CONABLE. Inventories had been going up slightly?

Mr. McCRACKEN. Slightly, very slightly.

Representative CONABLE. And that expected increase in inventory was also expected to give some push to production ultimately during the remainder of 1971, was it not?

Mr. McCRACKEN. Yes. And indeed as business activity picks up I would expect a further push there.

Representative CONABLE. Is it true the savings rate was still about 8 percent?

Mr. McCRACKEN. That is correct.

Representative CONABLE. In other words there had been no substantial fall off in the savings rate even though retail sales had generally been rising through the year.

Mr. McCRACKEN. That's right.

Representative CONABLE. Now, if that is so, how can you feel that a tax cut would have a substantial stimulative effect?

Mr. McCRACKEN. I would base my expectation of a lower saving rate on two things and both are very important to consumer confidence. If we can get a quickening in the expansion of general business activity so that job opportunities are opening up more rapidly, this can have a powerful effect on consumer sentiment.

But there is another aspect. Based on pretty careful research, we find that stronger action to deal with inflation tends to have a buoyant effect on consumer sentiment. Or to put it the other way around, greater uneasiness about inflation will be associated with a deterioration in consumer sentiment.

Representative CONABLE. I realize that strange inversion seems to take place psychologically.

Mr. McCRACKEN. Yes.

Representative CONABLE. You would think that inflation would have the opposite effect, that people would want to buy rather than accumulating depreciating dollars.

You are putting all your emphasis here though on the stimulative side on private spending. You are cutting back on foreign aid, you are cutting back on public employment, you are cutting back on the total amount of public expenditure by $4.7 billion or something of that sort, and it seems to me that of the two you get a much more quickly and dependably stimulative effect on the public side rather than on the private side because of this high rate of saving which has been demonstrated to be an idiosyncrasy of the modern consumer at least during the last year and a half. You don't feel that that inconsistency is significant?

Mr. McCRACKEN. No, I am not greatly worried about that. Of course the import surcharge will have a fairly immediate effect. In fact, some companies have already readjusted their production schedule as between foreign and domestic operations because of that. The great problem with trying to achieve stimulus on the spending side is that it is very hard to turn off.

Representative CONABLE. Now, with respect to the 10 percent surtax on imports, do you have to have any legislation on that, Mr. McCracken? It has been pointed out that you have some serious problems in areas like automobiles where there is only a small increment the President can add before he reaches the maximum tariff chargeable on such a commodity. Is it likely to have a major impact in the areas where you need it the most?

Mr. McCRACKEN. I think it is going to have quite an impact. Even in the case of automobiles where the surcharge cannot go up the full 10 percentage points—as you indicated—it can go up 6.5 percent. That with the adjustments in the exchange rates which we seem to be getting will have rather consequential effects.

Representative CONABLE. So you don't think legislation will be needed, in other words?

Mr. McCRACKEN. Not for that aspect of the program.

Representative CONABLE. And certainly not for the 3-month period of the program we are talking about which is a certainty at this point.

Mr. McCRACKEN. Not for the freeze.

Representative CONABLE. Has the movement of currencies been satisfactory from the point of view of our Treasury Department generally? There has been some movement as a request of further floating of the dollar on foreign exchange markets generally. Has it been as much as you expected and has it been the sort of movement which could lead to the early suspension of the 10 percent import surtax or has there been some disappointment about the extent to which the dollar has moved? I realize that many of these foreign countries hold a lot of our dollars and probably don't want to see it devalued to any substantial extent because it affects their own wealth. But how do you assess the movement that has taken place since this surtax was imposed, since the purchase of gold was suspended?

Mr. McCRACKEN. It always seemed to me unreasonable to expect an immediate and sharp change in exchange rates. This is based partly on the experience we have had in other cases where currencies have

floated. A fairly modest initial movement has more nearly been the experience and that seems to have been the case this time.

I think we find that other nations have a certain schizophrenia here. The weakness in our own balance of payments has been something about which they have given us rather stern lectures. But on the other hand, the kind of adjustment in exchange rates that will equilibrate cost levels and strengthen our balance of payments has to create a relative weakening someplace else, and those countries understandably are reluctant to face up to that.

Representative CONABLE. Well, all of this means the devaluing of the dollar on foreign exchange markets is somewhat unpredictable. Are you generally satisfied with its performance so far?

Mr. MCCRACKEN. Yes.

Representative CONABLE. We have six major commercial powers, the United States, Japan, Germany, Canada, Belgium, and France, that are now acting in technical violation of the IMF charter. There is an IMF meeting 3½ weeks from now. Do you expect an effort to amend the charter at that time? Do you believe the charter needs amendment? What kind of amendment would you support? Will we be doing away with the international monetary system as we presently know it? It certainly sounds like an unstable position if we are in violation of the charter to this degree. Do you contemplate any international conferences in the immediate future in addition to this to try to bring some order out of the uncertainty that we now have as a result of the U.S. moves? That's a lot of questions I have thrown at you.

Mr. MCCRACKEN. Yes. As to what may occur at the IMF meetings or subsequent international meetings, I could not really comment. In my own view, the study of the International Monetary Fund about a year ago—a study which by itself did not take a position—pointed the way to some things that do need attention. You may recall that the IMF study examined the possibility of a transitional float, a widening of the bands, and measures for achieving changes and adjustments in exchange rates more readily.

Now, all of these have a certain logic. If an exchange rate is out of adjustment, there may be a point to a transitional float until there is some evidence as to what the equilibrium rate is. And the widening of the bands has a certain logic too. It would give the system a little more capability to roll with the punches.

It does seem to me one of our problems has been that the needed adjustments in exchange rates have been too difficult to achieve, and, therefore, we run with the disequilibrium too long. I do hope that we can achieve the kind of realinement of exchange rates which will give us an equilibrium pattern of international costs and prices and work a little more flexibility into our system so that system, which has been a pretty good one on the whole, can continue to function.

Representative CONABLE. My time is up, Mr. Chairman.

Chairman PROXMIRE. General Lincoln, when the President announced this program he did refer to the fact that the $5,000 fine would be assessed on these violators. You have only had 2 weeks to operate this program and they have been 2 very hectic weeks I am sure, but I think its success is in whether or not the people of this country feel it is being enforced fairly and effectively or whether there is an effort

to enforce it. What have you been able to do about the complaints you have gotten? You say you refer them to the U.S. district attorney, appropriate U.S. district attorney. Can you give us any idea of how many of these complaints have been referred and whether or not you have any indication of what action is being taken, if any?

General LINCOLN. Yes, sir. In my mind the success of the program depends very heavily on two interlocking items: One, the support of the American people, including the various sectors of the economy; and, second, the feeling of the American people that it is being enforced fairly.

I want to make clear that complaints of noncompliance can go either to the local Internal Revenue office or to my regional office. We prefer normally that they go to the local Internal Revenue office because there are 360 of those in operation. My 10 regional offices have rather overpowering responsibilities and a small staff and more often than not, and I will not get into detail, the Internal Revenue office can resolve the matter without referring it.

Now, we certainly don't have our reporting system completed yet, but as of Friday there were 1,700 plus complaints in our system of my regional offices, my national office, and 360 Internal Revenue offices. I consider that that is a small number compared to the vastness of our economy.

Chairman PROXMIRE. I am sorry; I did not understand it. You say 1,700 complaints——

General LINCOLN. In the total system of the chart that I showed you.

Chairman PROXMIRE. And 360, you say were—360 were Internal Revenue offices.

General LINCOLN. No; 360 Internal Revenue offices.

Chairman PROXMIRE. I see.

General LINCOLN. Ten regional offices of mine and my national office.

Chairman PROXMIRE. I see.

General LINCOLN. Complaints have been coming into my national office. Our procedure is to hand all complaints to the Internal Revenue Service, to their network, and ask them to investigate. And I have fragmentary records of what is happening on that, and for your record, it may be useful if I give you the press releases that we issued on Thursday and Friday on that subject, if you wish to put it in the record.

Of these 1,756, by the way, 56 percent had to do with prices, there were 218 of them about rent, 467 about wages and salaries.

The rent complaints, by the way, tend to be concentrated geographically; as near as I can determine in the short time I have had them, in the New England area, New York area, and the Chicago area.

Chairman PROXMIRE. Without objection, they will be placed in the record at this point.

(The press releases follow:)

OFFICE OF EMERGENCY PREPAREDNESS,
EXECUTIVE OFFICE OF THE PRESIDENT.
Washington, D.C., August 26, 1971.

CONGRESSIONAL AND PUBLIC AFFAIRS

To assure the dissemination of adequate information on the President's Economic Stabilization program and to foster voluntary compliance, District Directors of the Internal Revenue Service will develop an orderly system involving

all its employees, especially Revenue Officers, Revenue Agents, Special Agents, Alcohol, Tobacco and Firearms Investigators, and regional inspector personnel.

This was announced on Wednesday evening by George A. Lincoln, Director of the President's Office of Emergency Preparedness, in remarks made at the weekly Newsmaker Night at the National Press Club in Washington, D.C.

During the course of their regular assignments, IRS employees have been encouraged to assist proprietors with problems in interpreting provisions of the wage/price freeze.

Lincoln commented that thousands of IRS employees will be assisting OEP's mission of monitoring the Economic Stabilization program as a by-product of their normal duties, thereby eliminating the necessity for increasing the size of the OEP staff to cope with this additional responsibility.

Office of Emergency Preparedness,
Executive Office of the President,
Washington, D.C., August 27, 1971.

Congressional and Public Affairs

While there has been a moderate increase in complaints from citizens alleging violations of the President's wage/price freeze, the total number of complaints received during the past week is remarkably small. Indications are that persuasion and voluntary compliance have been effective in resolving the majority of reported violations.

These are the observations of George A. Lincoln, Director of the President's Office of Emergency Preparedness, which is administering the Economic Stabilization Program.

As of noon on Thursday, the seven Internal Revenue regions throughout the Nation reported a total of 1756 complaints, more than 56% of them having to do with prices. There were 218 complaints about rent and 467 about wages and salaries.

Lincoln commented that action on instances of failure to comply with the freeze have not yet been carried to the point of formal action. Initial steps, however, are being undertaken principally by officials in the Internal Revenue Service.

The OEP Director added that he is heartened by reports that alleged violators are taking action immediately to conform with the wage/price freeze when they are informed of the problem. For example, a chain restaurant raised some prices after August 15, but rolled back the increases following notification by a regional authority and after the restaurant manager had received permission to do so from the main office.

Other cases reported from regional centers throughout the country portray a pattern of attempts to make moderate increases in the price of many goods and services, or of other problems involving labor and management.

One landlord had planned an increase in the rental price of his furnished apartments. Frustrated by the freeze order, he instituted a charge for towel service which had previously been furnished without charge. The local office of IRS is investigating.

A citizen called the national office of OEP and complained about an increased price in a supermarket. After a call from the OEP Legal Counsel, the proprietor agreed that he was in error and rolled back the price.

An apartment rent increase was ordered effective September 1st. The representative of the Department of Housing and Urban Development, working at the OEP regional office, called the landlord and he agreed to back down.

A luncheonette was accused by a customer of increasing its prices immediately after the freeze. IRS investigated and found that the latest price list containing certain increases was posted on August 13 and was therefore in order.

The president of a corporation called an OEP official and informed him that a number of employees planned to strike if they did not receive wage increases retroactive to July 1. The president was willing to accede to the employees' demand, but was not sure if he could. The OEP official met with the president of the corporation and the union leader and obtained agreement from both parties that the men would continue working pending a decision on the matter in Washington.

A complaint was received regarding price increases at an Air Force commissary. The Regional Compliance Office authorized an investigation which is now taking place.

A lady called and reported that a housing authority had raised its rent by $10.00. OEP assigned the case to IRS. IRS contacted the housing authority and found that the error had been discovered by the housing authority itself and the rent increase rescinded.

In one OEP region, a motor hotel withdrew its commercial rate of $16.00 per day and offered only the $18.00 a day rate. Similar to other complaints within the region, this was turned over to the IRS for investigation. What categorized this incident as something out of the ordinary was the fact that the OEP Regional Director is living at the motel.

Other cases include an incident in which three shrimp boats arrived at a dock to unload their catches. They found that the buyers had dropped their prices by five cents per pound to increase their profits without increasing their prices. In another incident, a large trailer park owner had charged $30 per month trailer rental. After the freeze went into effect, he instituted a $5 per month "rubbish removal fee" which previously had been provided for in the rental fee.

In most cases, noncompliance actions have been rescinded after some persuasion by OEP and IRS officials.

General LINCOLN. Now, as to what is happening, we find, as we check on these, the Internal Revenue checks on these, that a certain proportion of the complaints are not in fact warranted. We require a signed complaint, we don't want an anonymous complaint. We have had quite a few of those, of course, but we want them to fill out a form and sign it. We find that quite a few of these complaints in fact are not warranted. The fellow who, for instance, was just running a sale on the weekend of the 14th and his price now is in accord with the guidance. That is one group.

A second group is the individual storekeeper, whoever he is, who just didn't know what the policy was. When you talk to him, why he moves back.

A third group: He knew what the policy was but made his own interpretation and was a little reluctant to end it. But with skilled officials from the Internal Revenue Service—and now and then I see from the reports coming in, that skilled officials from other agencies—in the case of rent, a HUD man talked to him, or in the case of labor, a labor man, and after they are talked to for awhile why they will get in line.

Now, if the individual persists, the Internal Revenue Service will complete an investigation in the form that can be used by the local U.S. attorney——

Chairman PROXMIRE. I take it you really are not to that stage yet; it is too short?

General LINCOLN. We are not to that stage as yet. I should comment we were wondering a little bit about one case we had which reported quite a large number of railroads raised their rates, and I asked my regional director Saturday, late afternoon, to send them all telegrams pointing out what the Council guidance was. We had a little difficulty, by the way, in finding the addresses of the 28 railroads. We asked them, just asked them, what they were going to do about it. This is the normal first step that one can take. I think I might here turn this over to Mr. Weber and ask him what he thinks happened. Do you know what happened for certain on that, Arnie?

Mr. WEBER. Rather than talk about the railroads in isolation, you are asking generally, Mr. Chairman, about the question of compliance.

Chairman PROXMIRE. Let me just followup on the railroads a little bit. Are you persisting on that? I presume if the railroad did increase their rates over what they had in the month of August or 30 days preceding August 14 they are just in violation?

Mr. WEBER. Yes, sir. As the general indicated, they had raised their rates as of August 16 and it was a question of interpretation because it was an intrastate rate increase which was related to an interstate rate increase covering the same lines which had taken place in March. We sent them a telegram, and I received word, which I must say at this point is unofficial—but a telephonic communication indicated that on the basis of the telegram sent by OEP the railroads all agreed to roll back to the rates which existed prior to August 14 and to rebate any overcharges.

Representative CONABLE. May I ask a question? Aren't you going to run into a problem with your regulated industries?

Mr. WEBER. No, sir.

Representative CONABLE. Where they put in requests for rate hikes in the past and the only reason they haven't got it is Government inaction?

Mr. WEBER. No, sir. It is a normal procedure and we view that as part of the freeze. It is analogous to what is happening with deferred wage increases.

Representative CONABLE. Even where it is only Government inaction that has resulted in failure of the rate increase?

Mr. WEBER. I don't think it is fair to say, Mr. Conable, it is Government inaction.

Representative CONABLE. Many of these rate cases have been sitting for a long time.

Mr. WEBER. Many prolonged procedures are involved with regulatory practices: (1) they are complex, and (2) the parties want a fair shot and submit complex briefs.

Representative CONABLE. I am not quarreling with you but I wanted to ask that question because that has come up in similar situations in the past with respect, particularly with respect to ITC where you had completed contracts for purchasing and yet the purchase was not completed because of failure of approval of Government agencies.

Mr. WEBER. Well, I think that is right and I think that goes to the point of a freeze as contrasted to a set of controls. A freeze, in a sense, involves maintaining the relationships as they are at a particular point in time. A system of controls involves procedures and criteria whereby you try to rectify the inequities that ultimately must be resolved over time because adjustments are permitted.

Representative CONABLE. In other words, during a freeze you are not that concerned about equity, only economics?

Mr. WEBER. Well, somebody once said all great truths are great paradoxes, and it turns out that in a freeze you are most equitable, we think, by being consistent even if consistency carries with it the preservation of certain inequities over a short period of time.

Chairman PROXMIRE. You wanted to finish, you had a thought you wanted to finish, Mr. Weber.

Mr. WEBER. I just wanted to say on the compliance issue, Mr. Chairman, there are these 1,700 cases and, of course, there are those cases which have great public visibility. Questions of interpretation and

compliance have arisen concerning the Department of Defense, concerning the State of Texas, concerning the Georgia railroads, and concerning some hapless laundromat owner in Syracuse, N.Y. I am pleased to report that in all cases compliance with the general regulations was brought about on a voluntary basis once the applicability of the program was explained to the parties.

Chairman PROXMIRE. Well, we have the visibility, and I think where in this first period at least you shouldn't have much trouble but the problem is what you are going to do about the vast areas that are pretty much invisible, No. 1, and, No. 2, whether or not it is wise to continue the use the of the Internal Revenue Service as extensively as you do. No. 1, they have their own jobs; No. 2, it is a question of whether they have skills in this area. Mr. DiSalle testified before this committee about a week ago and it was his opinion if you are going to continue this program at all you are going to have to have a regular staff, not people borrowed temporarily or people being used from other agencies. Do you gentlemen agree with that, General Lincoln and Mr. Weber?

General LINCOLN. Could I make a comment on that about the supposed invisibility? So long as the country is generally with us, the fragmentary reports that I get through my regional directors indicate between 80 and 90 percent strongly support the program. The regional directors are in close contact through their normal duties with Governors and leadership. We will get told if there is really a violation that goes beyond the margin. I will give you an example of something that might have gone unnoticed.

Looking at one of my examples here is a description of a complaint. "A motel no longer offers commercial rate of $16 per day, now only offers $18 a day rates." I suppose they had two rates and you would think that might go by unnoticed.

"Action taken: OEP asked IRS to investigate. Results not yet determined.

"Comment: Case is unique because this hotel is where the OEP regional director is staying."

Chairman PROXMIRE. Well that is visible. That is one of the invisible situations that turn out to be visible.

The reason I asked that is I noticed that Mr. Nader has suggested that he may set up, do his best to set up, a consumer, a nationwide computerized network of consumer group watchdogs to police the price freeze in supermarkets. Would you regard this as constructive and useful or would you have any comment on it?

Mr. WEBER. No. Without specific reference to Mr. Nader's enterprises, I think, as Mr. McCracken indicated and General Lincoln indicated, we feel that public awareness and voluntary compliance are very important instruments to bring about an effective program. To the extent that activities of that nature generically forward that objective, we think they are salutary.

Chairman PROXMIRE. Let me get back to the original point that I was trying to make about the size and permanence of your operations, the skills and ability of it.

Mr. Taylor, whom we all respect and who has had a lot of experience in this area——

Mr. WEBER. Yes.

Chairman PROXMIRE (continuing). Said for wage and price controls to be effective some sort of mechanism must be developed to handle complaints by both the consumers and businessmen. He said during our two previous experiences with wage and price controls the office that handles price and wage stabilization had staffs much larger than the staffs you have now and he felt that unless your staff is expanded considerably that cooperation from individuals, labor, and business will be undermined.

You get a period of cooperation that you can expect and predict for a few weeks, but it begins to break down as people feel it doesn't add up to anything.

You cannot rely on it. It is not effective.

Mr. WEBER. I think that is a significant comment, and Professor Taylor, of course, has had wide experience in this area, and I think it is significant to put on the table what some of the numbers are historically in this area.

In World War II—which in economic terms almost looks like the age of innocence compared with the economy in 1971, the labor force was probably around half, GNP probably around half—there were 68,000 full-time Federal employees concerned with the administration of a systematic program of wage-price controls, and, I am told, 230,000 full-time volunteers. That makes some 300,000 people.

Chairman PROXMIRE. So you would feel now it would be 600,000?

Mr. WEBER. Well I wouldn't——

Chairman PROXMIRE. Well, maybe 450,000 to 600,000.

Mr. WEBER. Of course, there have been a lot of improvements in communications and we think our lawyers are smarter and economists wiser in that area. [Laughter.]

In the Korean war——

Chairman PROXMIRE. You are right on the first one; you are wrong on the second one, economists are wiser and lawyers are not smarter.

Mr. WEBER. The good thing about that judgment is, it is reversible.

In the Korean war, I guess there were 17,000 people who worked in a relatively simple approach.

Now, we have a wage-price freeze. The President has indicated that he would not like to see a massive bureaucracy established and I think even from a technical, managerial point of view for a 90-day period you would not want to set in place a wholly new bureaucracy. Indeed it probably would be impossible. So we have engaged essentially in an operation of what you might call systematic improvisation. The lead was given to OEP and I think OEP has done a magnificent job in this area under the leadership of General Lincoln. They had a mobilization capability, a communication net, and an economic stabilization planning responsibility which was in being.

So here was the agency to give responsibility in this area. We need a field capability. Again IRS—because it is able to interpret technical financial rules and convey them in a meaningful way to the public and because of its capability in the investigative area, it seemed to us to be a natural—and thanks to the cooperation of Secretary Connally, we brought them in.

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Chairman PROXMIRE. I am not asking about cooperation but what are you going to do to succeed for the rest of the 90-day period? For the longer period when we seem to agree the general consensus is we will have to have something, and it is going to have some clout as Mr. McCracken has indicated.

Mr. WEBER. Well for the rest of the 90-day period we think we have built up to personnel levels and field capability which will be adequate for the job. We are obviously monitoring this very closely, and if it proves to be inadequate we will attempt to supplement it from other sources. I think it is important to note that in IRS we now estimate we have 2,000 people involved and IRS has something like 60,000 people on its staff. In terms of what comes after the freeze——

Chairman PROXMIRE. Compared to the 300,000 we had in World War II you have 2,000 now.

Mr. WEBER. No; we have got probably around 5,000 in all—that is right. But remember, this has all taken place in a 2-week period and actually all these people were onboard in around 10 days, and the availability of additional resources provides some cushion or flexibility.

What comes after this will be determined, of course, by which options are selected with reference to stage two; the staff requirements will follow the program.

Chairman PROXMIRE. Yes; but it is hard to envision an option that would not require a more substantial staff than OEP has, I would think.

Mr. WEBER. Without in any way prejudging what option would be selected, if you go to a simple review board procedure, for example, which is essentially sort of institutionalized jawboning, where there is a prenotification, and the price or wage increase is analyzed, and then the wage and price board makes a recommendation to the public—that would not require a large staff.

On the other hand, if you went to some more comprehensive system you would obviously require a larger staff.

Chairman PROXMIRE. One other question along this line. When we heard the testimony from the former administrators of price controls, Mr. DiSalle said he thought the $5,000 fine was grossly inadequate. He said they had a million dollar fine on one occasion, you are going to have to have a far bigger fine. A $5,000 fine for a small businessman or an individual is very serious, for a corporation it is not enough, not even a wrist tap. Do you feel we should modify that as soon as Congress reconvenes to increase that penalty?

General LINCOLN. Mr. Chairman, there is also a provision for injunctive action in the Executive order. We haven't gotten so far down the road that I have examined precisely the language on this $5,000 business, but I believe it is per item.

Chairman PROXMIRE. Is what?

Mr. WEBER. Per violation, and that is an open question. We think the law can be interpreted so that if you overcharge or exceed the price ceiling on a can of peas it is $5,000 fine per can or per infraction.

Chairman PROXMIRE. Per can of peas.

Mr. WEBER. Or per infraction and that is a way of getting a little more visibility—but that I leave to final determination in the courts.

Chairman PROXMIRE. But what is the lawyers' view on that? It is very interesting. I wondered about that.

Representative CONABLE. You already said you don't trust the lawyers. [Laughter.]

Mr. WEBER. They think that that approach has some legal feasibility.

Chairman PROXMIRE. They think that may be?

Mr. WEBER. Yes, sir.

Chairman PROXMIRE. Mr. Conable.

Representative CONABLE. I have several unrelated questions that I would like to ask here. Mr.McCracken, I assume we are not going to do anything with our $10 billion worth of gold? We are not buying or selling any more for the time being. Presumably it would be possible for us to unload it on the market at $40 or $45 an ounce and get a fiscal dividend. We aren't going to do that, are we?

Mr. MCCRACKEN. I am not aware of that.

Representative CONABLE. Thank you. I assumed we were not.

With respect to the repeal of the excise tax on autos, that is something that is going to come to my Ways and Means Committee in the House. The repeal of this excise tax, in your opinion, is likely to result in more auto sales, I am sure, this year than we otherwise would have and not simply a shift from foreign autos to domestic autos. In effect it is going to reduce the price of autos to have this excise tax repealed. Do you see any long-range implications in this, that we are making further commitment to the automobile as the means of mass transit? Do you feel that we might want to study the impact of telling the auto industry the only direction is indefinitely up in terms of sales?

I just have some reservations about this, and I wonder if you would comment on it?

Mr. MCCRACKEN. Yes; that is a very good question. It is impossible to estimate precisely what the value of this might be in terms of increased automobile sales—probably something like 400,000 or 500,000 would be a rough guess. The estimate of the price elasticity of demand for cars varies all over the lot. Now, I think the logic of this is that here is an industry which is having imposed on it, both from a safety and from a ecological standpoint, very substantial increases in costs per car over the years ahead and, at the same time, it is one industry whose major product is still subject to a Federal manufacturers excise tax. Most of the others have already been weeded out of the Federal tax system. This is one way to deal with an aspect of our balance-of-payments problem, to stimulate the domestic economy, and also to redress the potential imbalance here in social costs that the industry and the buyers of those products will have to carry.

Representative CONABLE. Well, you do anticipate that this will result in less imports of automobiles? We had roughly 20 percent imports in our local market, haven't we?

Mr. MCCRACKEN. A little bit less than that; 16 percent, I think.

Representative CONABLE. May I also ask does this affect our arrangement with Canada on automobiles?

Mr. MCCRACKEN. Our arrangement——

Representative CONABLE. That supersedes the import surtax, does it not, the auto agreement with Canada?

Mr. McCracken. Yes; it does.

Representative Conable. Well——

Mr. McCracken. If I may interject here, the import surcharge and/or whatever adjustment in exchange rates we get, of course, alters the balance between domestic and foreign produced cars. However, the excise tax applies to all of them.

Representative Conable. With respect to the investment tax credits, we have had a very bad history here in Congress on the use of this. We have had it off again and on again so frequently that it has confounded business planning and tended to, I think, result in a lot of business planning being rather unsoundly based on tax consideration rather than on purely economic considerations. A 10-percent investment tax credit imposes a much greater temptation to try to use it for fine-tuning purposes than a 5-percent one does. Here you are deliberately moving in with a 10-percent investment tax credit to try to bail out the machine tool industry this year, now, immediately; and how can we have any confidence that this will not shortly be repealed again?

You say you want a permanent investment tax credit now. From my viewpoint, the acceleration of depreciation is a much sounder planning tool than an investment tax credit. Because of this congressional history and because of this temptation to use it for short-term purposes, can you tell me what statistics in the machine tool industry justify taking this step again?

Mr. McCracken. The machinery industry is particularly weak. New orders there have been low, activity in general is flat, and that suggests the desirability of doing something fairly promptly which would have a stimulative impact on that industry.

I am sympathetic, however, with the basic point that you are making that if the investment tax credit is put on, taken off, and changed too frequently, then it simply confuses business planning. Indeed, an economist from one of the European countries said that in his judgment it has been changed too frequently in this country to have any effect on business planning. Not knowing what to count on, businesses simply disregard it.

Representative Conable. I am interested in the relationship between the machine tool industry and the auto industry. We have a 9-percent unemployment rate in Michigan. I assume that is largely because there were no model changeovers this year and, therefore, very little retooling necessary in the auto industry because I notice that autos, despite the high volume of imports, have fairly well been assured they will have the second best sales year they have had, so there is no reason for widespread unemployment in the auto industry. The problems must be in the related industries which normally can count on substantial model changeover business from automobiles and, in particular, machine tools.

Is there anything to that assumption?

Mr. McCracken. Yes; I think there is. I suspect that another aspect of this, on which I don't have the facts at my disposal at the moment, is that the State of Michigan has probably been accounting for a declining percentage of the total employment in the industry.

Representative Conable. All right. It was said, I think, by Mr. Weber, that back in World War II we had an age of innocence compared to what we have now in our economy. Let me ask you though,

Mr. Weber, isn't it true though we have had a considerable greater concentration in our economy in the big unions and big industries since that period of time, and doesn't that therefore bring a substantially greater part of our wage and price decisions into the public view than used to be true back in the age of innocence when small business was much more the norm than it is now?

Mr. WEBER. Well, that in a sense is a fact question that relates to the degree of concentration which has occurred over the last 25 years, and, as you know, Congressman, that is a very complex and often very controversial question. I think I can say in my own area of expertise—and I can let Chairman McCracken speak to prices—with respect to trade unions, in general, that is not correct. I mean trade union membership in absolute terms has been relatively constant. There has been a recent upsurge, but that has been primarily among public employees; and as a proportion of the labor force, it has declined.

But, on the other hand, the wage-fixing arrangements which are carried out in the unionized sector, many observers would maintain, have more of an emulative effect upon the wage-fixing decisions which are made in the nonunion sector. So in a sense, there might be a tradeoff as between the extent of union growth and the role that large unions play in the economy, as contrasted to the impact of particular decisions which are made by unions and management under collective bargaining.

Now, in the price area I would turn to Mr. McCracken.

Mr. McCRACKEN. I do not have at hand any data here. But my general impression is that statistics on the degree of concentration are quite mixed. They may show a slight change but probably not as much as we think.

Representative CONABLE. Well, in the price area you have to concern yourself not only with the retail level but, of course, all the other levels as well. It would still be your conclusion, would it, sir, that for the first 90 days it is probable that there will be pretty good cooperation, but that after that, if we are going to continue anything like the kind of freeze we are hoping to achieve during this 90 days, we are going to have to have a sharp increase in the bureaucratic enforcement level simply because of the increasing pressure on all sales levels of the inevitable inequities involved in a freeze.

Is that a fairly accurate assumption based on all human experience up to this time?

Mr. McCRACKEN. General Lincoln whispered to me yes and no; I think it depends a great deal on what the postfreeze structure is. As Arnie Weber was pointing out, if it were quite a detailed monitoring of the entire pricing system, then the answer would be yes. If one is thinking in terms of a review board for a limited sector of the economy, the answer may be no. I don't see any clear evidence that a substantially larger bureaucracy would be needed.

Chairman PROXMIRE. Mr. McCracken, on Sunday, August 15, the same day that the President made his speech, the Joint Economic Committee's report in this area was released. That report, of course, was drafted about a month before this and we recommended, and I quote and I would like to get your reaction as to whether this would not be a good sensible solution:

"As we repeatedly recommended" I am reading now from the report "specific quantitative price and income guideposts should be established, and a board should be created to collect and publicize price and income data and to administer the guideposts. This should be done without further delay."

Senator Humphrey states:

An independent anti-inflationary price and wage board should be created to set guideposts. We should call this board exactly what it is: The Anti-Inflation Board. This board should not only publicize price, wage and profit increases that are inflationary, but should, when necessary, recommend to the President the imposition of selective freezes on profits and wages in particular industries or sectors.

Would you comment on that recommendation in the light of what has happened?

Mr. McCracken. Quantitative guidelines for wages and prices have a great deal to commend them for the obvious reason that it is very difficult to translate general statements into what is meant in a specific case. At the same time, we need to be pretty much aware in developing these guidelines that to identify what they mean in any specific case is difficult.

For example, take the general guidelines that if we are to have a stable cost level obviously the average of wage increases must be equal to the average gain in productivity. But what does this mean in a specific case? It is a very difficult problem.

Chairman Proxmire. Well, we had experience with that from 1962 through 1966 which has been variously evaluated. Charles Schultze testified before this committee last week and his recommendation is that what we should do would be to use productivity as the base and then allow perhaps half of the increase in the cost of living in the preceding year. He said as time goes on that would phase out because the inflationary situation would substantially improve. What would you think of that kind of a suggestion?

Mr. McCracken. This is one kind of guideline. I think that is very similar to what the committee on price stability in the closing months of the last administration proposed.

This is a searching around for a formula which can give some quantitative guidance. I wouldn't pass judgment on this now, but I think some kind of quantitative guidance is desirable.

Chairman Proxmire. I would like to ask General Lincoln and Mr. Weber about what you are going to do about getting cooperation from labor? As you know, a number of labor leaders have criticized the President's program. They fear that wages will be more effectively frozen than prices. They argue the government has no power over business. All he has to do is say he is not going to violate the law.

Do you think the fears of labor are justified, and if they are to any extent at all what you are going to do about it?

Mr. Weber. Well, I think every group in the American economy has the right to ask themselves a question of whether a freeze or any system of controls will be equitably administered. Therefore the first thing we have to do is to try to demonstrate by our actions that it will be equitably administered, and is being equitably administered, within the framework of our statutory powers.

Second, obviously there was an exchange of statements which indicated some concern on the part of organized labor. Our general approach has been to try to maintain communications and establish some basis for consultation, as was indicated by Secretary Hodgson yesterday. I think it is significant that George Shultz, Secretary Hodgson, Assistant Secretary Usery and myself attended a meeting of the AFL–CIO Executive Council the week before last. Secretary Hodgson met with Mr. Meany last week. We think this provides a basis for an effective dialog.

Chairman PROXMIRE. We are delighted to see that. It was certainly a great improvement on the fireworks that we heard the week before. It was a great reassurance that may be something would come out of this.

Mr. WEBER. That is right.

Chairman PROXMIRE. But is it possible in your view, and Mr. McCracken I want you to speak on this too, to work out a voluntary program which labor will accept and which will be effective?

Mr. WEBER. Well, we hope so.

Chairman PROXMIRE. What kind of thing would you have in mind? I am not going to pin you down, of course, and you wouldn't give me any specifics; but what kind of consideration should we try to develop here, Mr. Weber?

Mr. WEBER. Well, I can't talk to the substantive considerations but it is clear from the statements of Mr. Meany, Mr. Woodcock and other union leaders, that an important element of any acceptable program would be labor's participation on some tripartite basis, and I think they have stated that explicitly, and it reflects a labor view and certainly the experience with such systems of control——

Chairman PROXMIRE. When you say a tripartite board, are you talking about the board that would administer the program or a board that would advise the Government on administering it?

Mr. WEBER. Well, of course, it depends—and again I don't want to get to specifics because, as Mr. McCracken said, that would be premature—but I think the general rule would be that whatever mechanism you have—at least from a labor point of view, the acceptability of any such arrangement would be enhanced to the extent that it would provide for tripartite representation. In a sense I feel a little hesitant about the discussions because I'm interpreting to you, or you are asking me to interpret to you, the conditions that labor would establish and, of course, Mr. Meany has proven himself to be a very forthright spokesman for organized labor. So what I am doing here is just sort of reflecting on what I viewed as their preferences by recent comments, and the history of labor participation in such arrangements.

Chairman PROXMIRE. Can you give us some of the alternative possibilities with respect to labor's clear interest on getting some kind of limitation on profits? Now the testimony, frankly, we had before this committee from outstanding economists was that they didn't think it was practical. They said the control on profits would not be right or reasonable.

These were people like Heller, Eckstein and others who have had as much labor support as any economists, but they say if you have an effective price control system that would control profits to the extent

you would have greater efficiency, and profit is the reward for that. At the same time labor people have hit so hard at this. Is there any kind of an approach we can get here that would leave room for some incentive for efficiency in this system for holding costs down and at the same time provide for a limitation on profits so it could not be excessive and they could not take advantage of the situation to increase their profits?

Mr. WEBER. I would let Mr. McCracken speak to that but there are two points that I can make that are appropriate. One, it is clear that the matter of what are you regulating, and what income shares are in and what income shares are out, are important for symbolic reasons of equity and probably substantively as well, as they affect the system.

Second, there has been much discussion about why an effort wasn't made to control profits within the framework of this freeze. Well, the answer to that is really twofold. One, profits are not specified in the statute, and our attorneys indicate that the statute which spells out wages and salaries, prices and rents would not be sufficiently comprehensive to include profits.

The second point that is to be made is that by the freeze being comprehensive, all the way up and down the line from the extractive industry and through the intermediate channels and the processors and through the retailers, you are to some extent controlling profits.

Chairman PROXMIRE. Let me interrupt. I was the author of the original law but not the author of the amendment which was added in the House to provide for this control but our committee will be possibly interested in this. If it is recommended and if we think it will be desirable to have a limitation on profits; what kind of legislation could you have to control profits?

What could you do? Supposing any of you gentlemen were in the Senate and you were concerned with this and you wanted to make something effective. As I say, the real regulator to keep costs down is the fact you have a profit incentive and don't you remove that incentive from holding costs down if you have any control of profits, how do we solve that problem?

Mr. McCRACKEN. Well, that is almost an inherent contradiction.

While one can perceive what a price on wage or rent ceiling is, profits, of course, are a function of a great many things.

Chairman PROXMIRE. Well, supposing we simply said that during the preceding 30 days or year that the profits could not exceed that particular level?

Mr. McCRACKEN. It seems to me that the only practical way of getting at that is through the tax route, and here you get into the severe disincentive effects you were talking about. If you have an excess profits tax of some kind, it weakens the incentive for efficiency in the economy.

Chairman PROXMIRE. Could you provide that part of the additional profits had to be reflected in a price reduction?

Mr. McCRACKEN. There is a problem of timing here. In many cases what the profits will turn out to be will be found only after the price has been charged, in other words, after the sales have occurred. It seems to me the most straightforward way of limiting profits is through the tax route but we have to recognize that that carries with

it some very important questions that have to be raised and considered carefully.

Chairman PROXMIRE. At least one Senator suggested an excess profits tax, an excess profits tax of 80 percent based, I presume, on previous average profit in the preceding year, preceding 2 years. We had a similar tax, I think, during World War II, did we not?

Mr. McCRACKEN. Yes. I think then it was a certain percentage of the base which was established by 3 years over a certain 4-year period or 4 over a 5-year period. This, of course, was to make allowance for corporations that may have had a problem with serious losses in the base period.

Chairman PROXMIRE. Mr. McCracken, in the President's economic report the Council said it expected the inflation rate reduced to the 3-percent range and when you testified before the committee in July you felt that was optimistic, that that was not achievable. How does the President's new economic program change your forecast of inflation by mid-1972 and by the end of 1972?

Mr. McCRACKEN. I think it substantially improves the price prospect. I would not want to get into any figures here.

Chairman PROXMIRE. I wish you would.

Mr. McCRACKEN. I think it would not be productive here, but it certainly is going to move the rate of inflation in the right direction.

Chairman PROXMIRE. You think it could moderate—let's see, what was your prediction in July, do you recall?

Mr. McCRACKEN. I think I gave essentially the same speech about being wary of figures.

Chairman PROXMIRE. No, I think you gave us a figure.

Mr. McCRACKEN. I don't recall it. [Laughter.]

Chairman PROXMIRE. You gave us a 3-percent figure originally, you gave us that figure of 3 percent and then in July I think you indicated it would be higher than that, 4 percent, about 4.5 percent.

Mr. McCRACKEN. I think my quantitative evidence was expressed in terms of higher and lower, not a figure.

Chairman PROXMIRE. One of the things that troubles me most about the President's economic program as far as stimulus is concerned is the reaction we have already had from the major employers and purchasers of capital goods. They were reported in a round up last Thursday about the effect of the President's program on their plans and they indicated that the investment tax credit just wouldn't have any effect at all. They didn't plan any increase because of it. Union Carbide's response was typical. They said, and I quote "we cannot and do not base serious consideration and purchasing plans on a 1-year investment credit proposal." They went on to say the firm makes its capital investment decisions 2 or 3 years in advance.

If that view is representative of most industry then how much of a stimulative impact will the tax credit have in the short run? It might increase profits because it would reduce taxes, but it wouldn't increase production purchases apparently and wouldn't thereby provide any new jobs.

Mr. McCRACKEN. It is a little premature yet to tell about this. Capital budgets are fairly long range affairs. This has been in the public domain only about 2 weeks. I am a little skeptical about statements

that it makes no difference. These statements sound very much like the statements made when the investment tax credit was first before the Congress, and those statements were not at all consistent with what was said about the significance of the tax when it was on the verge of being repealed.

Chairman PROXMIRE. Well, of course, when the investment tax credit was put in, the investment tax credit was considered then to be not a 1-year shot. It was considered to be a more or less permanent measure, was it not?

Mr. MCCRACKEN. It was so indicated.

Chairman PROXMIRE. This is a 1-year shot. Their objection in this is just a 1-year effort and this would not affect their investment plans. In some respect this may be reflecting the history that Mr. Conable was talking about. It was put on as a permanent thing. In fact the Secretary of the Treasury gave assurances that once on it would not be taken off or the request for it would not be forthcoming.

If it does work, investment credit works, and industry purchases new equipment and if the psychological impact does indeed stimulate a net increase of $15 billion in gross national product so we have better business, doesn't this suggest there will be more borrowing?

We will still have a huge Federal deficit, the Federal Government will be borrowing, doesn't this all suggest we are going to have a greater demand for money and, therefore, the price of money, interest would tend to go up? What do you do about holding down interest under these circumstances when all other prices are being controlled? Why shouldn't the price of money be controlled?

Mr. MCCRACKEN. If this total program gives renewed assurance in regard to the price level then the inflation premium in interest rates ought to be declining. How this will work out in terms of market conditions is not at all clear.

Chairman PROXMIRE. It is conceivable, of course, that interest rates could rise?

Mr. MCCRACKEN. It is conceivable, of course.

Chairman PROXMIRE. We have legislation that has not been used, but there is another law that Congress passed that became law that gives the President authority to ration credit, control interest, specifies particular rates that he could use as pegs, and so forth. Why shouldn't that be used at the same time as these other controls which have been put into effect?

Mr. MCCRACKEN. This will have to be considered. The initial reaction of interest rates to this program has been for them to go down.

Chairman PROXMIRE. They did go down, and they have gone down for the last 2 weeks, certainly there is no question about that.

Mr. MCCRACKEN. Right.

Chairman PROXMIRE. But I say there is a prospect that interest may go up and this is one of the things that the labor people have been concerned about as well as the rest of us.

Mr. Weber, how do you plan to involve Congress in the planning that follows the 90-day period?

Mr. WEBER. Well, the Council presently is working out formal plans for consultation with the various interested groups, both congressional and noncongressional, so I think it is fair to assume that we will try to

develop an effective way of having consultation with Congress, but I can't say with any precision and detail how.

Chairman PROXMIRE. Is there any possible optional action, any kind of laws that you would require or that you would expect might be required?

Mr. WEBER. I could not say at this point in time, Mr. Chairman.

Chairman PROXMIRE. You mainly had in mind consultation with Members of Congress, appearances before committees, but you don't have any specific proposal as yet; is that right?

Mr. WEBER. That is correct; not at this point. I would call appearances such as this a form of consultation.

Chairman PROXMIRE. This is helpful.

Mr. WEBER. But it certainly is a preliminary step at this stage of the game.

Representative CONABLE. But surely you will be consulting with Congress extensively about the part of the President's program that requires congressional action and that alone is going to bring about a great deal of congressional consultation. I think the chairman is primarily asking where do we go from here and that is going to be somewhat determined by what Congress does with present proposals.

Mr. WEBER. No doubt about it.

Chairman PROXMIRE. Mr. Weber, in your opening remarks you said something about assessing the freeze regularly, constantly, daily. After 2 weeks how do you assess the freeze, so far? How well has it worked and to what extent is it not working?

Mr. WEBER. Well, we have to determine between the appearance and the reality and hopefully there are connections between the two; 83 million people in the labor force, and over 4 million business enterprises and God knows how many landlords. Clearly there are different sorts of idexes that we have, and ultimately it is going to be some measure of what has happened to wages and prices, as you get those indexes telling us what has happened to these months.

Right now we are setting up that sort of recording and evaluating system. Right now, one of our best indexes, of course, is the magnitude and nature of the complaints, and General Lincoln has spoken to that. Similarly, there are various spot market indexes—one came out last week—and I guess it provided weekly fluctuations in 21 commodities, 13 of which were controlled, and of those 13 none went up and two went down.

Now, you know, you just can't put too much weight on a 1-week spot price index of a mixture of commodities, but the appearance in terms of complaints and in terms of what we see, and in terms of rollbacks or cancellation of prospective wage increases and price increases in certain very visible industries, gives rise, I think, to at least a basis for some optimistic assessment of the first 2 weeks.

Chairman PROXMIRE. When would you be in a position to make a pretty firm evaluation of the freeze?

Mr. WEBER. Well, I think it is very difficult. The next CPI comes out, of course, in September; but that catches developments in the early part of August which were not subject to the freeze. In addition, in the CPI not every good is priced every month so that even in October, when you get the September figure, you will be picking up

some goods that were last priced in June and then are priced again in September.

Chairman PROXMIRE. Then it would be the October release for September CPI that will be the first comprehensive one?

Mr. WEBER. I think it will have some significance; yes, sir.

Chairman PROXMIRE. And the October release of the unemployment figures, that would tell us how the economy is moving on that front in response to the President's economic passage?

Mr. WEBER. Well, any prudent analyst cites—there are a lot of indexes and you want to see how one relates to the other.

Chairman PROXMIRE. Are there other price indexes that are available before then other than the CPI?

Mr. WEBER. Of course, the wholesale price index, to the extent the freeze goes to wholesale prices, and then certain other indexes in the agricultural area and what have you. We are trying to identify all those ongoing statistical series which we can use to get a good crosscut analysis on how the freeze is working.

Chairman PROXMIRE. Mr. McCracken, I take it in your earlier response to Mr. Conable's questions you didn't give a specific estimate as to how much the value of the dollar should decline in relationship to other currencies; Is that right?

Mr. MCCRACKEN. No; I did not.

Chairman PROXMIRE. The estimates generally have been around an average of 8 or 10 percent. Would you fault that?

Mr. MCCRACKEN. I think it would not be appropriate for me to comment on any specific figure.

Chairman PROXMIRE. Should abolition or phasing out of the interest equalization tax, Commerce Department program to restrict foreign direct investment and the Federal Reserve's limitation on bank lending to foreigners, be part of the administration's program to establish viable dollar exchange rates?

Mr. MCCRACKEN. These are going to have to be looked at.

Chairman PROXMIRE. So it would be a good prospect that they might be phased out?

Mr. MCCRACKEN. That will have to be examined.

Chairman PROXMIRE. Might be phased out?

Mr. MCCRACKEN. The investment control program is something which the rest of the foreign nations have some interest in themselves so we will have to look at it.

Chairman PROXMIRE. I take it to the extent that we believe our dollar should float and should reach its value in the open free market, international market, that that would make it less necessary to have these other controls; is that right?

Mr. MCCRACKEN. Yes; in other words, prospective capital flows and the exchange rate are related.

Chairman PROXMIRE. Now, in view of the fact that the foreign exchange value of the dollar is sure to fall some, is there any justification for the administration's announced intent of continuing to seek legislative authorization which would require Congress to act, to implement the establishment of the Domestic International Sales Corporation? As you may remember DISC is a tax deferral scheme to stimulate exports, very, very vigorously challenged by Ralph Nader

when he appeared before us, I think with considerable merit. Should we subsidize exports on this basis if we are going to rely on the free market?

Mr. McCRACKEN. Yes, I think the DISC proposal is an important element of this total package.

Chairman PROXMIRE. Well, once again, is it not possible that that might be eliminated if we are going to have a floating dollar that reaches an appropriate level?

Mr. McCRACKEN. Certainly it is possible to think of an exchange rate which would be so favorable to the United States that we can handle any of these other developments. I doubt if exchange adjustments are going to be that large.

Chairman PROXMIRE. Once again this is another protectionist device along with the special kind of investment tax credit, along with the import tax; is it not?

Mr. McCRACKEN. It is a device by which we can have a better opportunity, whatever the exchange rate system is, of servicing our foreign markets from domestic production.

Chairman PROXMIRE. Is it possible to retain the import tax on a selective basis? Say we get some cooperation from some nations and not from others, would it be feasible, practical to apply this to those nations which were not cooperative?

Mr. McCRACKEN. This would certainly be highly discriminatory and I am sure would be strongly resisted by the rest of the world, but it would be possible.

Chairman PROXMIRE. Well, if we said if the rest of the world cooperated with us then it would not be applied to them?

Mr. McCRACKEN. In that case it would be upon them to react.

Chairman PROXMIRE. Would you give us your reaction, I guess you have not given to us, to the social security tax deferral? This is something recommended by this committee, this is something we feel would give effect to the President's proposal. It is a regressive tax, it would be the largest increase in that tax in the history of the Social Security System, largest increase if it is allowed to go into effect, how would you feel about the prospect of postponing it?

Mr. McCRACKEN. If this were added to the package that the President put forward, I would have some concern as to whether we were overdoing it by the latter part of 1972 or in 1973. We might——

Chairman PROXMIRE. For one thing it is 1 year, for another thing there is a $70 billion shortage of demand, we have almost five and a half million people out of work, we have 75 percent of our capacity only being used. Under these circumstances why would this stimulation of demand be inflationary or be overdoing it?

Mr. McCRACKEN. The expansion we have ahead of us ought to carry with it a significant further reduction in the unemployment rate.

Chairman PROXMIRE. Let me just bring up one point that Mr. Heller stressed very hard and the other economists did very hard, too. They seemed to feel you are stimulating investments very heavily here, that it is misplaced. What we need right now is not more investments when we are operating at such a low proportion of capacity, we need more consumption and to stimulate the consumer you need something of this kind, and this kind of a tax deferral would directly and

specifically stimulate the consumer inasmuch as the low income groups would be more likely to get the benefit of it and they spend a higher proportion of their income and demand would be accelerated.

Mr. McCRACKEN. I think that takes too static a view.

Chairman PROXMIRE. Takes too what?

Mr. McCRACKEN. Takes too static a view. Even in a period when the economy is operating at somewhat less than full employment and even in industries and companies which in the formal sense may have excess capacity, there is still a need for modernization and upgrading of productive facilities.

As I look at it, it is in the capital goods area that the economy is particularly flat. Consumer spending has been moving along pretty well this year.

Chairman PROXMIRE. Is it not flat for a very good reason? If you were operating a company at 72 or 75 percent of capacity what in the world kind of incentive would you have to go out and buy more plant and more equipment? You are already under-utilizing what you have got, are you going to buy something which is going to be idle 25 percent of the time? Is not the best way to stimulate the investment in the plant and equipment to stimulate consumption so that the plants will be producing more?

Mr. McCRACKEN. But consumption has been moving ahead fast. The area in the economy which has been quite weak has been capital spending, and if you look at any company you have facilities that will range all the way from highly modern and technologically advanced to those that are on the margin of being obsolete or may be obsolete. So there are always incentives to carry on with capital expenditures to upgrade and modernize and thus to make the productive facilities more efficient.

Chairman PROXMIRE. At any rate, the prime reason for the investment credit is to encourage companies to modernize, to invest in equipment, to provide more jobs?

Mr. McCRACKEN. Yes.

Chairman PROXMIRE. Under these circumstances how in the world can there be any justification for making the credit retroactive to April 1? I understand that Secretary Connally made a speech saying if it were put into effect this year it would be made retroactive. I have great respect for Secretary Connally. I think he has done a fine job especially in the last month or so, he has been most impressive but I do not see how his statement binds me or any other Members of Congress or why we should be concerned about that. It would not provide any more stimulus. It would provide a windfall for those who happened to have bought equipment between April 1 and August 14. Why should Congress make this retroactive?

Mr. McCRACKEN. I think the important thing is to stimulate orders from here on in.

Representative CONABLE. May I interject something there, Mr. Chairman? Is it not true that Secretary Connally made this statement at a time when he was concerned about the flatness in the machine tool industry and concerned that people were holding off because of all the talk here in Congress about reinstitution of the investment tax credit? Was he not concerned about the short run impacts that I was talking about earlier, with respect to investment tax credit?

Mr. McCracken. Yes.

Representative Conable. He was attempting at that time to eliminate the lack of incentive that investors might have to buying machinery if they assumed the investment tax credit might be put on at a later date. Was that not the purpose of his statement?

Mr. McCracken. Yes, sir.

Representative Conable. And it was made at a time before the President's proposal. Therefore, you have a serious problem of the credibility of Government if he goes ahead and says, "Well, I am sorry, fellows, I really did not mean it. April 1 is not the deadline. Now we are going to move it up to August 1."

Chairman Proxmire. It would be a lesson in civics, it seems to me, for American business. They should realize the Secretary of the Treasury is not the Congress itself. He can recommend it but it seems to me, it is for the Congress to determine whether to put it into effect April 1 or August 14. I know of no Member of Congress who made that promise. If they did they only speak for their own vote.

Representative Conable. That does not mean the Secretary of the Treasury is going to necessarily change his recommendation. If he recommended earlier, April 1, we do have a serious issue of credibility if he now changes. Members of Congress, of course, can follow their own views on this.

Chairman Proxmire. It would seem to me that the important thing, as the Chairman of the Council of Economic Advisers told us, it is a stimulus from here on, that is what counts, and if Secretary Connally did give the impression that he could make this prevail that is his responsibility. I think the only thing he can do, and I presume the only thing he did was to say he would recommend it. It is up to us to decide what to do about it.

Representative Conable. This is exactly the problem with the investment tax credit—this kind of manipulation. It is a serious question whether we should rely on the ITC under any circumstances. There is a great tendency to maneuver back and forth the specific stimuli that would have to apply to the making of railroad equipment and pollution equipment and every other sort of thing that comes down the pike.

Chairman Proxmire. Let me, I have detained you gentlemen a long time but I would like to ask another question, another short series of questions, because I think they have not been covered in the questions we have asked today.

You argue, Mr. McCracken, that this program will be substantially stimulative, that it will provide for a $15 billion stimulus net. It is very puzzling and very difficult for us to see where this comes from. The budget changes proposed by the President match revenue loss with expenditure cuts as you said, there will be very little net change in the budget deficit; is that correct?

Mr. McCracken. Yes, that is right. But as I indicated in my testimony, to say that the only significance of the import surcharge is simply the revenues collected would certainly be to miss the main economic effect, which is to substitute domestic production for imports.

Chairman Proxmire. Well, do you take into account the increase that the surtax causes, results in the cost of living?

Mr. McCracken. Oh, yes; sure.

You are talking about the impact of this on the CPI?

Chairman PROXMIRE. Yes.

Mr. MCCRACKEN. Whatever shows up in price would show up in the CPI.

Chairman PROXMIRE. And also that which the President's program postpones, welfare reform and aid to State and local governments, it speeds up aid to business?

Mr. MCCRACKEN. Yes.

Chairman PROXMIRE. Why is it essential to postpone welfare reform? If this is a permanent program, the program is to be put into effect a year from now, a program which a year from now could conceivably be inflationary if the economy expands, but the President is now recommending it not go into effect this year but next year. The President first called for the welfare program 2 years ago, August 1969 as I recall, and he has put a very high priority on it up until recently. Now he says that it should be deferred and postponed. From the economic standpoint why does that make sense?

Mr. MCCRACKEN. I think there is a question as to what kind of a timetable would be realistic under any circumstances for these two items. But in any case the slippage of these items as a part of the total package of expansion, I think, is something which makes sense.

Chairman PROXMIRE. Let us concentrate on the welfare reform package. That is one of the elements that makes this Nixon package look biased and unfair. The people in the economy, in this society who are the most neglected and suffer the most, the most in need of assistance, the system that has been most strenuously criticized for its great inefficiency is the welfare system which is now going to be allowed to continue in its present state and meanwhile I have not heard any argument that to move into this new program would have any adverse economic consequences at all.

In your view, would it be inflationary right now to proceed as rapidly as Congress would proceed with the welfare reform program?

Mr. MCCRACKEN. To the extent that it resulted in additional spending, it would have that degree of further inflationary and expansionary effect.

Chairman PROXMIRE. But, as I say, we have a $70 billion gap between the desirable demand and actual demand and welfare reform would be a matter of what, $5 or $6 billion at most if it were put into effect for 4 years?

Mr. MCCRACKEN. Yes; but there is a problem here. This carries with it the implication that so long as the gap exists, the more stimulus you put into the economy the better. Now this was precisely the problem we ran into in the mid-sixties when we collided with the ceiling and then had a period of inflation, and consequently——

Chairman PROXMIRE. Certainly in the period of the late sixties you would be absolutely right inasmuch as we had very low unemployment. Unemployment down below 4 percent and a $23 billion budget deficit. There is no question about it the Federal Government did contribute heavily to inflation. But to provide for a stimulus now on the order of $5 or $6 billion additional when you have this enormous deficiency of demand seems to me is not analogous at all.

Mr. McCRACKEN. But it is precisely at this stage of the game that we have to ask ourselves what kind of a path the economy ought to be tracing out as it reenters the zone of full employment. In the mid-1960's we gave inadequate attention to that question, and the result was that instead of being able to ease into the full employment path by the latter part of 1965, the economy was rising too sharply. There was no possibility of making the needed transition. While we do not like unemployment and want to eliminate it as soon as possible, if we take the attitude that the more expansion at this stage the better, we will court the danger of getting the kind of expansion going which will produce the 1965 experience over again.

Chairman PROXMIRE. Well, supposing—instead of cutting the excise tax on automobiles—supposing you put in the welfare reform measure. Would this be a washout? In other words, would it have the same effect?

Mr. McCRACKEN. In terms of its impact on consumption and on the overall economy in the longer run, it would probably tend to leave us with a weaker economy.

Chairman PROXMIRE. A weaker economy?

Mr. McCRACKEN. Yes. That is, an economy with less capability for productivity gains.

Chairman PROXMIRE. We would have fewer automobiles?

Mr. McCRACKEN. Pardon.

Chairman PROXMIRE. Fewer automobiles? We would have every child in America with an assurance that they would have enough funds to have enough food and clothing and shelter so that they could begin to lead a reasonably dignified life, far below the poverty level, but nevertheless, better than now. Why would it leave a weaker economy? It seems to me, in terms of the principal economic resource, the people of this country, we would have a stronger economy.

Mr. McCRACKEN. Budgetary priorities in the last 3 years have been shifted enormously in the direction of programs of social welfare, education, and that sort of thing. This has been good. But I think there is a question as to how rapidly you can go, and what we want is, among other things, to maintain and enhance the basic productive vitality of the American economy.

Chairman PROXMIRE. How long will the President's impounding of funds appropriated continue under these circumstances? Do you have any view on that? The President impounded some $12 billion of appropriated funds, about $1.3 billion, for example, in the area of housing and urban development.

Mr. McCRACKEN. I think Mr. Weber can probably speak to that better than I. My general impression is when you look into this you will find that a very substantial part is highway construction. Some other parts are moneys that are withheld pending progress payments on projects that are underway. Actually, the amount of money impounded is not out of line with the budget.

Mr. WEBER. It was estimated to be $2 billion that we are actually impounding. I know Mr. Weinberger has testified.

Chairman PROXMIRE. It is what, how much?

Mr. WEBER. $2 billion actually.

Chairman PROXMIRE. $2 billion?

Mr. WEBER. Were actually impounded.

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Representative CONABLE. In housing?

Mr. WEBER. No; overall total.

Chairman PROXMIRE. Overall?

Mr. WEBER. Yes; that was the thrust of Mr. Weinberger's testimony. I am not prepared——

Chairman PROXMIRE. Mr. Weinberger's testimony, when?

Mr. WEBER. I guess it was some time before the recess. He appeared before various committees of Congress to discuss the question of impoundment.

Chairman PROXMIRE. Well, Mr. Weinberger at one point appeared before the Senate Banking Committee when I was present and he did not refute the argument that we made that there was a total of $12 billion impounded by this administration and $1.3 billion for housing and urban development which was that committee's jurisdiction.

Mr. WEBER. I think it goes to the definition of what you considered an impoundment but I am not prepared to talk in detail on this, and people from OMB will be able to supply the detailed breakdown of the impounded funds.

Representative CONABLE. Mr. Chairman, I believe his testimony also was $12 billion was fairly close to the average over the past years as to the amount of money that is in the pipeline and for one reason or another being withheld.

Mr. WEBER. That is correct. It was a smaller proportion of the budget that was in question.

Representative CONABLE. I want to ask one other question, Mr. Chairman. The welfare program proposal at least has passed the House. I have not seen any great anxiety of the Senate to pass it at this moment judging from the comments of the chairman of the Finance Committee. It would cost $5 billion. The revenue loss from the repeal of the 7-percent excise would be $1.9 billion; is that not correct?

Mr. MCCRACKEN. I think it is a little more than that; $2.3 billion.

Representative CONABLE. So we are talking about a substantial increment to the proposed deficit which now runs, it is estimated, at around $20 billion.

Chairman PROXMIRE. You would have to make up a different package; you would have to maybe cut the investment credit to 5 percent and knock out the auto excise tax relief; they are not one and the same packages.

Representative CONABLE. Even in terms of exact dollars they are not the exact wash. One has probably three times the impact of the other.

Chairman PROXMIRE. Well, gentlemen, I want to thank you very, very much for appearing. You have been most helpful and I deeply appreciate it and I want to especially thank you for coming up during the August recess. I think coming before the Congress and this congressional committee at this time is very helpful. We are indebted to you very much.

Mr. MCCRACKEN. Thank you, sir.

Chairman PROXMIRE. The committee will reconvene at 10:30 tomorrow morning in this room to hear the former Chairman of the Council of Economic Advisers, Mr. Ackley.

(Whereupon, at 12:40 p.m., the committee was recessed, to reconvene at 10:30 a.m., Tuesday, August 31, 1971.)

THE PRESIDENT'S NEW ECONOMIC PROGRAM

TUESDAY, AUGUST 31, 1971

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:30 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire and Representative Conable.

Also present: James W. Knowles, director of research; Loughlin F. McHugh, senior economist; Richard F. Kaufman and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Bander, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Yesterday the committee heard testimony from three administration officials responsible for conduct of the President's new economic program. Unfortunately, but understandably, they were unable to spell out what will follow the present temporary policies. The Joint Economic Committee will continue to seek expert advice on what ought to follow. I would like to announce this morning a change in our schedule of witnesses for the remainder of the week. Leonard Woodcock, president of the United Auto Workers of America, will not appear Wednesday as scheduled. He will appear later.

On Wednesday, in addition to Mr. Arthur Okun, the committee will hear from Mr. Edward M. Bernstein. Until now our attention has been focused primarily on the domestic aspects of the President's economic program. Mr. Bernstein's reputation as an international economist and his participation at the Bretton Woods Conference that established the present international monetary system make him uniquely qualified to evaluate the international aspects of the new economic program. Mr. Bernstein, after receiving his Ph.D. from Harvard, taught and worked as an economist with the Department of the Treasury. In 1944, he was the chief technical adviser and executive secretary to the U.S. delegation at Bretton Woods. He later served as Director of Research at the International Monetary Fund and is now president of his own research firm, EMB Limited.

This morning we are fortunate to have as our witness Mr. Gardner Ackley, former U.S. Ambassador to Italy and former Chairman of the Council of Economic Advisers. We are especially fortunate to

have Mr. Ackley because he is gifted in many areas but particularly, I think, he can speak with great authority with respect to the freeze and its consequences and what should follow the freeze. In fact, I know of no one better qualified to speak on this issue.

Mr. Ackley served in the Office of Price Administration during World War II and again as an assistant director of the Office of Price Stabilization during the Korean war. As a member, and then as Chairman of the Council of Economic Advisers during the 1960's, he participated in developing the concept of price-wage guideposts and gained several years' experience in their administration. Most recently Mr. Ackley is the author of a study for the Atlantic Institute entitled "Stemming World Inflation," which surveys the use of incomes policies in the major industrial countries. He is thus uniquely well qualified in terms of both academic study and practical experience to comment on the potential and the pitfalls of policies of voluntary price and wage restraint.

I do not mean to imply that Mr. Ackley is qualified to comment only on the price aspect of the President's new policies. As a professor of economics at the University of Michigan and author of one of the best known textbooks on macroeconomics, he is also an outstanding expert on the use of fiscal policy. And the experience gained as Chairman of the Council of Economic Advisers and then as Ambassador to Italy from 1968 to 1969 make him well acquainted with the intricacies of international trade and monetary arrangements. So we are looking forward to your remarks, Mr. Ackley, in all aspects of the economic situation.

Before you proceed, I would like to ask consent to have inserted in the record an important statement released yesterday by the chairman of the House Banking and Currency Committee and vice chairman of this committee, Representative Wright Patman. Representative Patman's statement comments on the failure of the administration to plan ahead to meet the clear need for a price-wage policy and points out how advance planning might have averted the need for sudden crisis action and the present uncertainty about what happens next. Representative Patman also calls for a rollback in interest rates as an essential ingredient of balanced economic policy. Without objection, Representative Patman's statement will appear in the hearing record at this point.

(The statement follows:)

STATEMENT OF HON. WRIGHT PATMAN ON PRESIDENT NIXON'S WAGE-PRICE FREEZE

WASHINGTON, D.C., August 30.—Chairman Wright Patman of the House Banking and Currency Committee charged today that the Nixon Administration had been derelict in its failure to carry out advance planning for the wage-price freeze.

"The administration of the wage-price authorities is being made much more difficult and is creating more confusion than is necessary because of the monumental failure of the Administration to order contingency planning," Mr. Patman said. "The Administration was caught up in its emotional, philosophical opposition to the wage-price law and, as a result, the bureaucrats buried in the various agencies did little to prepare for an eventuality that has now become a reality."

Mr. Patman said that the blame for the lack of planning, the failure to properly use economic data, and the failure to prepare the nation for the new economic program should be placed at the front door of the White House.

"It is President Nixon—echoed by Vice President Spiro Agnew and his various economic advisors—who repeatedly told the public and the Federal bureaucracy

that this Administration would never—under any circumstances—use wage-price authority," the Banking and Currency Committee Chairman said. "The results of these many months of blind opposition are now reflected in the confused and hurried regulations which are being issued to carry out the authority."

Mr. Patman said that the President should have ordered the Office of Emergency Preparedness, the Treasury Department, the Council of Economic Advisers, and the Federal Reserve System to draft specific and detailed contingency plans the moment the law was signed a year ago. He said the Administration should have put a battery of economists on the project to study the trend of wages and prices in each industry and determine—in detail—where the distortions and inequities existed.

Mr. Patman said such a program of planning would have enabled the Administration to impose the wage-price freeze "in a more imaginative manner and without inequities in any sector."

"Instead, the Administration is now faced with studying the inequities and distortions after the fact and trying to issue orders with only the most limited information available," he said. "The Administration is allowing exceptions in some areas without knowing exactly how these exemptions affect the total economy and without knowing what other inequities exist."

Mr. Patman said the wage-price authorities can work only if they are administered with an even hand and "this is possible only if a great deal of advance planning has been conducted." He said that the Office of Emergency Preparedness was primarily a planning agency for emergencies and it is "regrettable that this agency did not have a series of model programs already established for implementation the moment that the President issued the orders." He said it was disgraceful that many local OEP offices appeared to have no concept of the wage-price law and no knowledge of plans to implement the act after the President's speech the night of August 15.

"With the Commander-In-Chief saying 'never, never' the economic generals and colonels throughout the Administration were obviously asleep at the switch," the Texas Democrat said. "It was a leadership and Administrative failure at the highest level of the Federal Government."

Mr. Patman said he felt that the Administration had implemented the wage-price law in the least imaginative way possible. He said he did not feel that a flat 90-day freeze on all prices and wages was the best use of the Presidential authority.

"The law, as passed by the Congress, gave the President authority to set prices at any level existing since May 25, 1970 and he was not restricted to the price and wage levels in the 30-day period prior to August 15, 1971," Mr. Patman noted. "In some areas of the economy, it would have probably been wiser to have selected different dates as the base period if there was a real desire to provide economic stabilization."

Mr. Patman said that if the Administration had made proper use of the available information beforehand, it would have been possible for "more flexible and imaginative orders to be issued in carrying out a stabilization program." He said the Administration could also have established formal guidelines or other criteria for wages and prices based on productivity levels and taking into consideration cost of living increases.

"Such a procedure would have been much more equitable and would have allowed workers, whose wages may have been lagging in recent months, to have caught up with cost of living increases," Mr. Patman said. "But we have an inflexible freeze which fails to take into consideration the differing performances of various prices and wages in the past year."

Mr. Patman said that any successful wage-price program must be accompanied by a sharply stepped-up effort to provide new job opportunities.

"Much of labor's opposition to the program would undoubtedly be diminished if the Administration would take concrete steps to provide new job opportunities and to provide more realistic retraining projects," he said. "The wage-price freeze means little to the man who is out of work and has no wages and no money with which to meet any price which might be set."

Mr. Patman again called for a substantial rollback in interest rates as "an essential ingredient of the wage-price program." He said the Administration could not expect to hold wages or prices in line if it did not control interest rates.

"Interest rates are reflected in every single item in the economy and it is absurd—and highly inequitable—to have left the lenders out from under this

new economic plan," Mr. Patman argued. "In the case of interest rates, the Administration should not resort to a freeze, but a rollback to reasonable levels for all classes of borrowers."

He said such a rollback would make it much easier for the workers—as well as the businessman—to cooperate with the wage-price freeze and would "do more than anything else to stabilize the economy."

Chairman PROXMIRE. Mr. Ackley, please go ahead.

STATEMENT OF GARDNER ACKLEY, HENRY CARTER ADAMS UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, UNIVERSITY OF MICHIGAN

Mr. ACKLEY. Mr. Chairman, I am very grateful for that warm introduction and reception that you have extended to me.

I am pleased to appear before this committee today to explore some of the issues raised by President Nixon's new economic policy, announced 2 weeks ago. I am pleased to appear because I believe that the President's dramatic switch of direction in economic policy—although seriously flawed in several respects—at least represents the repudiation of a course of action which was pointing toward disaster. It has provided this Nation—and to some extent even other countries as well—with an opportunity for a new start in more constructive directions. It seems to me most important that this opportunity not be thrown away. As on so many occasions in the past, your committee will play a crucial role in the redirection of economic policy now taking place in this country. If I can contribute anything to your deliberations, I shall be more than happy.

I intend to be highly selective in these comments. I do not intend to discuss the parts of the program relating to the dollar and the international monetary system. I have views on these matters; but your committee can call on many economists far more expert than I am in this area, and whose judgments will be more important for you to consider. I shall even refrain from extended comment on the fiscal aspects of the President's program, not because I do not have strong views on these aspects, but because I can record them simply by saying that I am in essential agreement with the positions on fiscal policy recently expressed to you by my former colleague, Walter Heller.

Instead, I want to concentrate on the price-wage aspects of the President's program. This is an area in which I have perhaps had as much and as varied experience as any of the economists appearing before you so far. Beginning in July 1941, and for most of World War II, I worked in a variety of commodity areas of the Office of Price Administration—and, in its predecessor agencies, engaged in "jawbone" price control. I rose, ultimately, to the highest level of responsibility in OPA that the Congress—through its "anti-professor amendment"—would permit an academic economist to hold. Somehow, I was persuaded to accept double jeopardy, and served as a price controller again during the Korean war—as Economic Adviser and Assistant Director of the Office of Price Stabilization. On my return to the University of Michigan in September 1952, I devoted substantial effort for a year to the preparation of a book-length study of some crucial aspects of the Korean war price controls, under a contract with the Office of Defense Mobilization. Then, during my more than 3

years as Chairman of the Council of Economic Advisers, I served as one of the principal agents of President Johnson's efforts to restrain inflation through the promulgation of "guideposts" for noninflationary wage and price behavior, and through repeated and numerous interventions—made both publicly and privately—in the attempt to prevent or moderate important price and wage decisions that were judged inflationary.

These experiences have stimulated a longstanding professional interest in the economics of inflation and its control, a subject that I have dealt with repeatedly in my research, writing, and lecturing. One of the papers of which I am most proud, entitled "A Third Approach to the Analysis and Control of Inflation," was prepared at the request of this committee, and published by it in its compendium of papers, "The Relationship of Prices to Economic Stability and Growth," March 31, 1958. My most recent publication is a monograph entitled "Stemming World Inflation," published last month by the Atlantic Institute.

Unfortunately, this long experience and reflection has provided me with more questions than answers, and has developed a great skepticism about the validity of all dogmatic views on this most complex, most delicate, yet most important subject of inflation and its control. However, it is often useful at least to know what the right questions are.

THE FREEZE

Although not all of my professional colleagues agree with me, it is my view that, having waited so long to take any effective action against inflation, the administration probably had little choice but to invoke a freeze, as the necessary first step toward getting a handle on the problem. I congratulate the administration at least for its decisiveness, and for knowing not to give any advance hint of its thinking—which could have made the problems of the freeze even more difficult when that step finally was taken.

I think that the freeze will work, in the sense that the rise of prices will be virtually halted for at least 3 months. At the very least this will spare us from having to listen to three more of those monthly explanations why this month's increase in the CPI or WPI was unusual and next month's will be smaller, or—if the month's increase should happen to be more favorable—exultant claims that inflation is now being conquered. In fact, the freeze can do even more than this. Even 3 months of virtual stability, if properly used, can be significant for the whole future course of prices, as I will try to show.

However, one thing everyone agrees on is that the freeze contains dramatic distortions and inequities—as is always the case when a freeze suddenly stops in midcourse prices and wages that have been rising rapidly. And that is precisely when a freeze is usually invoked. So long as the freeze is brief—and 90 days is probably close to the limits of tolerance for a rigid freeze without adjustments—these distortions and inequities can be ignored, and the freeze can work. But further perpetuation of these inequities would quickly erode the public support or at least tolerance of those affected—which has to be the basic reliance of any system of direct wage and price restraints. After about 90 days, too, enforcement—which may not be a significant

problem in the early weeks or months of a wage-price restraint program—would begin to loom as a major problem; and the freeze is not easily enforceable.

What then should happen on or about November 14?

One solution would be simply to end the freeze, replacing it with nothing. If this were done, some small contribution might have been made to the slowing down of inflation. But if there is any such contribution, it will not have been worth the fuss and fury, the hardships and inequities suffered, the expectations aroused and disappointed, the new bitterness or resignation engendered. Almost everyone agrees that this must not happen.

If it is not to happen, the freeze must be replaced after 90 days or thereabouts with some other form of restraint that is more viable. I want to outline some of the basic considerations which, it seems to me, should guide our choice of that substitute system. These considerations relate both to the nature of the new system when it is fully in effect, and to the means of transition to that system from the freeze. The first of these choices is, however, the more basic. Problems of how we can get there from here—difficult as they may be—can probably be handled once we know where it is we are headed. First, however, let me make three or four general points which are more or less independent of how these choices are made.

FISCAL SUPPORT FOR THE TRANSITION

The first observation is that, because the early stages of any restraint program require more sacrifices—or surely appear to do so—than are necessary once the program is in operation—for reasons that I will explain in a moment—it seems to me highly essential that we have a rapidly expanding economy as the new restraint system takes hold. Many businesses are going to have to do things about their prices that they won't like. Wage increases will often be less than workers think are fair. The pains and stresses of this period will be greatly eased if profits are being supported, or even allowed to expand, through greater sales volume, the spreading of overheads, and the abnormally fast productivity gains that come with rapid expansion of output; and if labor incomes are being enlarged through the return to full work weeks, increased overtime hours, and the expanding availability of employment for the wives, husbands, or teenagers in workers' families. I am not here making the argument, sometimes heard, that faster expansion automatically reduces the upward pressures on costs and prices. I happen to believe that faster expansion under present circumstances would not add much to inflationary pressures—but it surely would not reduce them. Rather, my point is that, if society is asking or demanding restraint, cooperation is more readily forthcoming if incomes are rising than if they are stagnant.

Thus, it seems to me absolutely essential that both fiscal and monetary policies be unmistakably geared toward expansion in the months ahead. Any doubts should be resolved on the side of expansion. In my view, this reinforces the considerations advanced by Walter Heller in favor of a substantially more expansionary fiscal policy than the President proposes.

My second general observation is that we must not exaggerate the difference between systems of restraint that are called compulsory and those called voluntary. Even the most fully compulsory system cannot work for long in a democratic society unless it has at least the tolerance of those regulated as well as broad support by the general public. This support or tolerance can usually be assumed to be forthcoming in a nation at war, or facing a profound emergency. It cannot possibly be taken for granted at a time like this.

Suppose that a labor union in an important industry regards a compulsory wage ceiling as unjust, and goes on strike for a wage increase in excess of the ceiling. Whether the wage ceiling survives this challenge surely will depend on the extent to which other unions—and the general public—support the restraint system or the strikers. Suppose that a major industry, or industry generally, believes that its compulsory price ceilings are creating serious hardship. Business does not have a weapon quite like the strike; but, as an old price controller, I know that there are often many ways—legal, questionable, and illegal—to take advantage of almost any price regulation. Moreover, the history of price controls is replete with episodes of major industries demanding approval of what the regulators have determined are unjustifiable increases in price ceilings before they will settle with their unions for wage increases which the law permits to be paid. They are thus in a position to force a strike unless their price ceilings are unjustifiably raised. Where then are your compulsory price controls, unless they have at least the tolerance of other businesses, as well as the strong support of the public?

What I am saying is that any successful stabilization system—"compulsory" or "voluntary"—demands the consent of those whose wages and prices are to be stabilized. For this consent to be forthcoming, those regulated—and the general public as well—must see the system as one that is basically fair and equitable, or, at least, that embodies sacrifices by "our side" that are roughly equivalent to those imposed on the "other side." Moreover, members of each group must believe that the restrictions its members accept on their freedom to do as they please will achieve something important—that slowing down the rise in prices is a highly desirable objective, and that this system will be effective in achieving it.

In my view, this consent can only be forthcoming through a widespread participation by all groups in our society—and particularly by the organizations of labor and business—in a process of recognizing quite explicitly the need for the program, and in determining the broad features of its initial design and, thereafter, its modification and redesign. With all due respect for the abilities of Herb Stein and Arnie Weber, and indeed, of all members of the Cost of Living Council, they are not going to be able to dream up a plan, announce it to a waiting world, and then expect it to work. To a considerable extent, the Kennedy-Johnson "guideposts" were simply dreamed up by economists and then promulgated. I have long considered the absence of any real participation by the interest groups in the origination and modification of the guideposts—and, as a consequence, the absence of any sense

of responsibility on their part for the success or failure of the effort—to have been the greatest weakness of the guidepost system.

On the other hand, you cannot simply summon a group of businessmen and labor leaders and tell them to agree on some plan. The requirement instead is for political leadership of the most superlative quality, leadership which I believe can only be provided by the President himself. Somehow, he and his associates must bring together, both separately and jointly, representatives of all segments of the public and of all major interest groups, explaining, exhorting, proposing—as necessary, conceding, cajoling, and threatening—ultimately finding compromise both of form and substance which will permit at least a significant proportion of the leaders of every group in fact to support—and, in public, at least to appear to tolerate—what is an effective program of restraint. Economists can help to decide what can and cannot be conceded and still have an effective program. But, essentially, the task of constructing a new system of restraints is one for political leadership—and of the highest order. Moreover, it is a process that will necessarily take considerable time. It will not be accomplished in one big mass meeting in the East Room.

In peacetime—and in a Presidential election year—it may well appear to be almost impossible to negotiate a social compact among the great economic interest groups in support of any "voluntary" stabilization plan. But let us not believe that—if this should be the case—we can then simply opt for compulsory controls. Perhaps we can; but unless the social compact is subsequently achieved, the controls will not last. Moreover, any such social compact tends to become unstuck over time; its maintenance and renewal must be a continuous objective of statesmanship.

THE NEED TO PLAN FOR THE LONGER TERM

My third general comment is this: what we are building to replace the freeze on November 14 must not be considered a temporary system that will serve for a year or so and can then be forgotten. Every bit of historical evidence—and it is all around us—and every consideration of economic analysis convinces me that the problem of creeping inflation, or perhaps I should say walking inflation, is not going to disappear. Any modern industrial society that is determined—as ours surely is—to permit, at most, brief lapses below full employment is bound to suffer continuing or recurrent inflation unless a whole range of permanent institutional changes is undertaken to contain it. This, I suppose, is the principal message of my "Stemming World Inflation." I will not here repeat the argument why inflation must now be considered "endemic" in the Western World; but I believe it most strongly.

That does not, of course, mean that the system we adopt on November 14 need be a system that we expect will last forever. But it is surely relevant to some of our choices.

BREAKING THE PRICE SPIRAL

In thinking about the transition to longer-term arrangements, it is important to understand clearly why it is that an inflation—like ours

today—tends to keep on rolling long after its initial cause—whatever that may have been—has disappeared. Indeed I have come to believe that understanding the "initial causes" of inflations—those which might convert a situation of price stability into one of price rise—is often less relevant than understanding how a price spiral keeps turning once it has begun. Unfortunately, there are many kinds of things that can set off an inflation—not all of them always avoidable. Understanding how inflation perpetuates itself is often considerably more important than determining whether it was really the chicken which preceded the egg or the reverse.

One key to understanding the inflationary process is the recognition that not many prices and, particularly, almost no wage rates are adjusted continuously. Rather, they are predetermined for periods that often run up to 3 years for wages, and even longer for some long-term price contracts, or regulated prices. Some individual prices and wages come up for revision each day or week, but only a small proportion of the total number. If an inflation is to slow down, obviously today's wage and price increases must be smaller than yesterday's, tomorrow's smaller than today's, and so on.

Those who are making decisions each day are adjusting a wage or a price that has not changed for some time. If prices and costs, including the cost of living, have been generally rising during this period, then the purchasing power of the existing wage rate has been steadily eroding ever since it was established; and the profitability of the existing price may have been eroding ever since it was last changed. The rate of this erosion is determined by the pace of the inflation. With each new adjustment of price or wage, the seller expects—an expectation generally regarded as entirely legitimate—to restore the real value of the preexisting wage or price as of the time it was last changed—that is, to "catch up" with subsequent changes in prices and costs—and, in addition, to secure some "normal" or "fair" rise in his real income—at least insofar as his real income is affected by prices and/or wage rates received and paid rather than by volume of work or production.

Whether, when people behave this way, an inflationary spiral will accelerate, decelerate, or continue its previous pace can be shown to depend on the magnitude of the desired increments of real income which each new wage or price tries to achieve. It is possible that the prevailing concepts of "fair" or "normal" income increases for individuals may, in the aggregate, be consistent with the gains permitted by the continuing increment of real output—that is, of productivity—which is occurring in the economy. In that case, the adjustments being made each day in wage rates and prices will simply perpetuate whatever rate of inflation has been occurring. If the rate of inflation has been zero, it will remain that. If it has been 6 percent, it will remain that. However, if the aggregate expectations of "normal" or "fair" increments of real income which wage and price decisions attempt to provide should exceed the growth of aggregate real output, the rate of inflation will necessarily accelerate.

For sellers of labor or goods to participate in a self-perpetuating inflationary spiral does not require any of them to demand wage or price increases that will—in the average case—directly reduce the market for their services or products. If average wage rates have been and are generally advancing at about 8 percent a year, average pro-

ductivity at about 3 percent, and average prices at about 5 percent, individual employers who today agree to pay 8-percent wage increases can expect an average 5-percent rise of their unit labor costs. If their individual price increases should therefore also average 5 percent, this will not be out of line with the increases recently and presently occurring in other prices and costs, and in buyers' incomes. The wage rates and prices they set will not cause them to lose sales or their workers to lose employment.

To be sure, depending in part on the fiscal and monetary policies being followed, a given rate of inflation may be accompanied by some shrinkage—or expansion—of aggregate output and employment. But these global, impersonal forces of contraction or expansion have little impact on any given day's individual price and wage decisions—or, at least, overall contractionary forces are likely to have little impact in reducing the daily increments. Any individual wage or price setter who accepts smaller increments in the wages or prices he receives than have recently been occurring—perhaps because unemployment is high or markets are slack—does not thereby reduce the rate of increase in the prices or wages he must pay. Rather, he will just reduce his own real income and raise that of everyone else. Who knows whether unemployment will be increasing or decreasing in the months ahead—markets tightening or slackening—and whether or how this will be altering the rate of future erosion in the purchasing power of the wages and prices now being set? Catch up to where you were, get what else you think is fair or you can get away with, and, if possible, build a fence around your real income gains by an escalator clause—that is the only safe guide.

The spiral character of an inflationary process is why it is often so nearly pointless to argue whether it is labor or business—wages or profits—that are to blame for inflation, particularly once the inflation is well underway. The fault may simply be neither's; it is just that what labor and business do to try to protect themselves from an inflation in being turns out simply to perpetuate the inflation against which they are trying to protect themselves. The fault in this case is society's—for not providing a social mechanism through which labor and business can climb off of this treadmill. The freeze can be a vital first step in this process.

THE CONTRIBUTION OF THE FREEZE

If, beginning on August 16, the freeze halts all further new price and wage increases, then the pressure for price and wage increases later on by others will automatically also be reduced. After 90 days of this, the cumulative erosion of the real value of the wage or price that has been fixed for a year will be appreciably less than it would otherwise have been. When the time comes that something can be done about that wage or price, the pressures for catchup will be distinctly reduced—unless, of course, at the end of the 90 days. wages and prices are all allowed to jump up to where they would have been on that date in the absence of the freeze.

But, if, for 90 days—and then for another 90, and 180 beyond that—price increases, and wage increases in excess of productivity gains,

could all be distinctly reduced or even eliminated, the pressures for catchup—which are the basis for the perpetuation of the spiral—would increasingly be dissipated. "Catchup" is a force like inertia. If prices are in motion, it tends to keep them in motion; if prices are at rest, it tends to keep them at rest. That is why it is so difficult—yet so vital—to break through a spiral. That is why the pressures on a system of restraint are far greater when the objective must be to restore a reasonable stability of prices, if that has been lost, than when the objective is merely to preserve a reasonable stability already attained.

THE WAGE LAG

Most prices—as opposed to wages—are adjusted with reasonable frequency. Thus, there are probably relatively few prices now caught by the freeze that had not been adjusted or at least considered for adjustment within a month or so prior to the freeze. During the freeze, wage rates and material prices will not have increased. Moreover, productivity gains averaging nearly 1 percent—more if the expansion is rapid—will have occurred during this period, providing equivalent reduction in unit costs. Thus, at the end of the freeze, there should be little immediate need for price increases—other than, of course, some utility and transportation rates; some prices should even be ready to come down a bit. In any case, the immediate policy on price increases can be and ought to be fairly tough, providing only for cases of obvious inequity. If subsequent average wage increases could then be held equal to productivity gains, prices on the average could thereafter be stabilized about where they now are. Or, if wage increases could be held to 2 percent in excess of productivity, the rise of prices might be held to around 2 percent.

But, unfortunately, when the freeze ends, there will still be a fair amount of catchup needs on the wage side. Wage rates which were last increased early in 1971, during 1970, or even before, if not protected by a cost-of-living escalator, will need varying amounts of catchup in addition to any new real-income gains. Here, then, it seems to me, is the real nub of the problem of transition from inflationary spiral to reasonable price stability: What will happen to pre-August 15 wage contracts as they come up for renewal, and especially to those not previously containing escalator provisions? If it were possible to spread their cost-of-living catchups over several years, and to allow in addition only tightly defined productivity increases, reasonable stability of the price level might be achieved fairly quickly. For so tough a standard to be applied to new contracts, it would obviously also be necessary for deferred wage increases built into preexisting contracts to be superseded to the extent that they, too, should exceed a tight productivity standard. If these requirements are impossible to achieve, the best that any new stabilization policy can aim for is a rather painfully slow running down of the spiral. One of the crucial tests of the new system will be how effectively it can respond to these requirements for a prompt and lasting slowing down of inflation: An immediate tough control on further price increases; the spreading out over time of cost-of-living catchups; and the superseding of deferred wage increases that exceed productivity gains.

THE NATURE OF THE NEW SYSTEM

A wide variety of designs is possible for the system of restraints that will replace the freeze. It may be that the administration's planners are exploring some entirely new ideas; if so, it is understandable that they are not ready to talk about them. Public discussion, however, has so far been concentrated on only a few standard options, and the wide range of possibilities for social invention seems to me not to have been adequately explored.

Let me describe briefly four basic models that have been proposed, including some possible variants of some of them. These differ in the nature of the machinery and procedures that would be set up, in the extent or character of the enforcement that would be undertaken, and in other ways. For the present, I will concentrate on where we might want to end up, not how we get there.

PERMANENT CONTROLS ON THE CONCENTRATED SECTORS

First, there is the model that might be associated with the name of J. K. Galbraith: a system of continuing, indeed permanent, compulsory controls over the "concentrated sectors" of our economy—big industry and strongly organized labor—with the rest of the economy—agriculture, trade, personal services, some highly competitive manufacturing industries—essentially free of restraint. Presumably, prices would be regulated by detailed, what price controllers call, "tailored" regulations for each industry, each with appropriate standards and administrative machinery for permitting necessary adjustments and exceptions, for handling the pricing of "new" goods and services, et cetera. The wage regulations would presumably take the form of a series of detailed standards to govern wage and salary increases—including changes in wage and salary differentials—along with machinery of some kind to supervise the application of these standards in the negotiation of particular labor contracts and the construction of particular salary and fringe benefits schedules—including those applicable to presidents and chairmen of the board. A moderately large administrative staff would be needed because, in any permanent system, significant changes in the differentials among the millions of individual prices, wage rates, and salaries would be essential. Yet these changes in differentials would have to be rigorously controlled in order to keep them from affecting wage and price levels. Criminal sanctions would be available against every detectable violation of these regulations. However, with coverage limited to the concentrated sectors, enforcement would probably be relatively simple; the serious problems would not be those of detecting clandestine violation or evasion, but, rather, perhaps, meeting open challenges by managements or unions.

I assume that the ceilings would be set at levels such that most prices and wages would be at ceilings most of the time. Ceilings high enough that contact of prices and wages with ceilings was intended to be only occasional would merely invite the rise of prices and wages, with ceilings having then to be lifted from time to time, and perhaps more and more frequently. But if ceilings are designed to be in continuous contact with prices and wages—and some price ceilings to decline from

time to time, as would be appropriate—so that almost all actual changes in prices and wages are the result of changes in ceilings, then every major industry has become, in effect, a public utility. The controllers must take responsibility then for not only the prices but the quality of products and services; for assuring that adequate expenditures being made for social purposes—such as job training or pollution control; for the legitimacy of costs incurred—that is, for advertising; and for rates of return on capital—over and above approved costs—that would be both "fair" and would induce "necessary" or desirable investment. Yet these are not industries from which market risk is virtually absent, as is the case for utilities. Thus, if managers—or the controllers—guess wrong, and firms should sustain losses which—not offset by adequate profits earlier—threaten bankruptcy, must not the Government—a l'a Lockheed—come to the rescue? If absence of sufficient private investment has threatened to create future shortages, must not the Government then require and finance it? I think that I would prefer nationalization directly rather than indirectly and gradually.

On the wage side, are we really ready to accept permanent wage controls, which I think means essentially the abolition of the right to strike, except perhaps to achieve wage gains which the regulators permit but employers refuse?

And if controls are held tightly on the concentrated sectors, and wages or profits should ever rise faster in the uncontrolled sectors, will there not be irresistible pressures to extend the controls to those sectors, too, in order to prevent inequity?

I cannot believe that anyone can seriously think through the problems raised by permanent wage-price controls on the heart of our economy and still advocate it.

A NEW SYSTEM OF GUIDEPOSTS

A second model frequently discussed is a system of guideposts or guidelines—surely they will have to be given a new Republican name—presumably applicable across-the-board to all prices, wages, salaries, perhaps rents, and possibly dividends. These guidelines would resemble the Kennedy-Johnson ones, although they would probably be more detailed, with the exceptions spelled out more clearly.

The standards would presumably apply to all firms and unions, in all industries, even though their real impact would be intended for the concentrated sectors. There would have to be at least a small staff to help interpret the standards, to call attention to "violations," to attempt to persuade potential "violators" to refrain, to amend the standards as necessary. The tough questions arise when we ask how these guidelines might be enforced. One possibility is to rely only on public opinion. To allow for the more effective mobilization of public opinion, administrators might be given authority to require postponent of wage or price changes while their legitimacy is studied, to compel testimony and to publish reports and recommendations. But, in the end, the decision what price or wage to set would be made free of compulsion.

This seems to me to be a clear-cut and attractive proposal. Its perhaps fatal weakness is that it might not work. Some firms and unions

might be prepared to flaunt the guideposts, and the public might not care enough to make them change their minds. A certain amount of such violation is clearly quite tolerable—indeed it is a necessary and desirable safety valve. But once the violators become sufficiently numerous so that the cooperators feel that they are suffering serious inequity, the system must progressively break down. Recognition of this weakness prompts the suggestion of alternative enforcement methods.

One proposal—surely not serious—is to give the guideposts the force of law. This would make them into a system of comprehensive compulsory controls, across the board, using the most untailored and imprecise kind of self-administered wage and price regulation that one could imagine. Anyone who ever was closely associated with the old guideposts knows that the determinations they require are—particularly on the side of prices—both exceedingly complex and exceedingly approximate; for some of them, the only possible determination is an educated guess. I cannot imagine any court finding any firm or union, except the most egregious violator, guilty of violating a standard which can be interpreted only by an educated guess. And even if the violation is sufficiently flagrant to be penalized, what does the violator have to do to come into compliance? If, to avoid these problems, you attempt to make the guideposts sufficiently precise and detailed so that any violation might be determined in less than 5 years of litigation, you find yourself with a comprehensive wage-price control system that is an administrative nightmare, one that—as it is made more effective—loses all flexibility and begins to raise all the problems of permanent controls that I have just been discussing, except on an across-the-board basis.

A third guidepost variant is perhaps more promising—the provision, at least for a time, of some process which would permit legal sanctions to be invoked in the case of clear violations in highly important situations. I do not know precisely how it might work. But perhaps provision could be made whereby the authorities might seek from a special tribunal of some kind an order prohibiting a clear and open violation of the standards in a specific economically or strategically important case. The order sought would enjoin specified behavoir for a specified period of time, subject to penalties for violation. The complaint would be that the behavior sought to be enjoined was clearly and significantly in violation of fair and equitable standards which had been properly promulgated by the guidepost authorities, and which were being generally accepted by others. This "big stick" in the back of the closet, the use of which was not entirely predictable, could perhaps mightily enhance the force of public opinion in deterring clear and deliberate violations of the standards.

I think this last variant may have some promise.

A WAGE-PRICE REVIEW BOARD

Some have identified the guidepost approaches I have just been discussing with the institution of a wage-price review board. But it need not be the same thing at all. Suppose that Congress creates a wage-price review board of distinguished citizens—not, in my view, serving as "representatives" of specific interest groups—and gives it various types of procedural authority: To require advance notice of price or

wage increases under circumstances which the board may prescribe; to delay by order the effectiveness of any specific wage or price change for any period up to some maximum time limit; to compel the production of records and the giving of testimony; to publish such reports and recommendations—to the parties, to Federal, State, or local governments, to private groups or associations, to consumers, or to all of these.

Such a board would not have to begin operations by promulgating any standards—except perhaps in the broadest terms—or by specifying the scope of its jurisdiction. It would pick out its cases—basically ones which it thought it might win, and which it believed would be strategic for subsequent price or wage developments. It would use its powers to achieve what it thought was achievable, and, if possible, build up its authority by its successes. Sooner or later, its choice of cases and the nature and success—or failure—of its recommendations would begin to create a pattern of jurisdiction and of standards; but not necessarily a pattern fixed for all time. Possibly it, too, might be given some opportunity—through special procedures such as I have just described—to seek to give certain of its specific recommendations the force of law for specified periods.

As an economist, I prefer the approach that starts with generally applicable guideposts. But I am not certain that taking on the whole world all at once is necessarily the course of wisdom for a new institution.

INDUSTRY-BY-INDUSTRY MACHINERY

Some propose that the model of the construction industry councils be generalized, by creating similar machinery—which seeks to act by conciliation but backed by legal authority—for a number of industries. I confess to some skepticism about this approach, unless it is merely supplementary to one of the others. So far as I know, the machinery to regulate salaries and prices in construction has not yet been established. I do not believe that, in general, wage rates can or should be regulated without corresponding regulation of salaries and prices. I do not quite see how this kind of machinery can ever easily abandon an area of control on which it has entered; and I wonder if it is not a rather haphazard system of price-wage control, likely to grow like Topsy, with quite different standards applied in different industries. However, as an adjunct to a guidepost or review board system, I think it has real possibilities.

As I said earlier, there is wide scope for innovation in setting up new restraint machinery, and I believe that it is useful for public discussion to begin to focus more concretely on what the shape of the new system might be, and not simply to repeat phrases such as "a wage-price review board," or a "guidepost system."

MOVING FROM THE FREEZE

Without specifying the nature of the restraint system to be adopted after the freeze, it is difficult to make specific suggestions about the nature of the transition process from freeze to the new system. It should not, however, be taken for granted that, as of November 14, all prices and all wages must automatically move in one fell swoop from the

freeze to the new system, whatever that may be. Selected sectors might usefully remain temporarily under the present freeze; that is, prices of a selected list of basic industrial products when sold by their producers. Other prices or wages might remain temporarily under the freeze but with a specific, simple, self-administered adjustment permitted. But the freeze should surely be suspended on November 14 for all prices at retail—except possibly a few big-ticket items—all rents—except possibly where a city government asks for a temporary delay while it develops its own rent-control system—all personal services, wage rates in low-wage industries, and as much else as does not clearly require some transition period to the new arrangements.

While I see no reason why the transition to the new system need occur completely and simultaneously on November 14, I should hate to see any transition that would involve, for any appreciable number of cases, an intermediate stage of "tailored" price- or wage-control regulations, or any elaborate effort to "adjust" or "administer" the freeze for any large range of commodities or services. The Korean war experience surely proves what an administrative nightmare this would involve. Moreover if—as I believe—we are going to have to develop institutions that will be viable for a considerable period of time, I think that we must learn to stay as far away as we can from the traditional patterns of direct controls. They are indispensable in an emergency. But their role—if any—must be minimized under nonemergency conditions.

CAN AN INCOMES POLICY BE EFFECTIVE?

You may have noticed that I have not, up to now, used the term "incomes policy." There is often argument about what it means or should mean. Basically, I use it to mean an organized system of restraints on attempts to expand individual profits, wages, and other incomes through the raising of prices charged in the marketplace for products or productive services of all kinds. These restraints may apply to prices, wage or salary rates, professional fees, or whatever; but their purpose is to keep the attempted growth of individual incomes in reasonable line with each other and with the expansion of aggregate real output. The term also connotes an effort to accomplish this objective with minimum reliance upon legal sanctions. Yet, in fact, what are called incomes policies abroad run the whole gamut from pure exhortation at one extreme to complete compulsion on the other.

There should be no question that my preference is to depend on compulsion to the minimum extent that is consistent with reasonable effectiveness. This preference rests both on an ideological commitment to freedom and on observation and analytical conclusions about the distorting and ultimately self-defeating effects of widespread direct controls. However, the minimum amount of compulsion that may be necessary for effectiveness is not always the same; it depends on where you are and how quickly you want to move somewhere else. Right now, I would be willing to contemplate more compulsion at strategic points and times—in order to hasten the transition to reasonable price stability—than I would want to use or think is needed to maintain stability once that is achieved.

I think it is regrettable that the President has seen fit—in the past at least—to caricature incomes policies by identifying them with either one or the other extreme of the spectrum of compulsion: either as purely voluntary—in which case he has called them completely ineffective—incorrectly in my view—or as complete systems of State controls—in which case they are stifling and intolerable. Sometimes they are even characterized as both—completely ineffective and stifling—which is quite a trick. But the real question is how effective a policy can be which makes only modest use of legal sanctions. The record of effectiveness of incomes policies is not brilliant—although it may not be as bad as the platitude contends. Yet that does not prove either that they have been useless or that better ones cannot be devised.

I have argued here that consent of those affected and support by the general public are essential for the effectiveness of any system, voluntary or compulsory. Is it an illusion to suppose that such consent and support can be forthcoming? My reading of what labor and business are saying and feeling is that there is at least a good chance that it can be forthcoming, given strong and sympathetic political leadership. Those trying to lead must have conviction that what they are trying to do is feasible and worth doing. This is why the Herb Steins and the George Shultzes should not have central roles in the program. But a number of the leaders of labor and business understand—perhaps better than Stein and Shultz—that labor and business are on a treadmill that is getting them no place, and the general nature of what must be done to get off it. I have never had any doubt about the willingness of the leaders of organized labor to accept social responsibility for labor's actions, once they were convinced that the social requirement was both necessary and equitably imposed. And the June 1971 report of the Committee for Economic Development on "The Social Responsibilities of Business Corporations" shows how far many businessmen have come in accepting the need for business to subordinate immediate profit maximization to social objectives. Most Americans, I think, would regard the containment of inflation as an important social objective.

Once the need for restraint is generally accepted, and once the leaders of the main economic interest groups come to accept, however grudgingly, the general design of the restraint system—as the best they can expect to get—what is the role then of compulsion, in the form, presumably, of legal sanctions? It seems to me that the primary role of compulsion is to assure that the system is not undermined by the subsequent actions of a noncooperating minority sufficiently large and important to threaten to cause withdrawal of the support or tolerance of the majority. That amount of compulsion is probably a crucial requirement for the effectiveness of the system.

WHAT ELSE IS NEEDED?

Although I have long been a strong advocate and supporter of incomes policies I have tried never to exaggerate how much they can accomplish by themselves. I have always put it that they can make a modest but useful contribution. My second principal theme in "Stemming World Inflation" was that containing endemic inflation requires a whole range of instruments: fiscal and monetary policies, incomes

policies, "structural policies," and a serious attack on the whole range of private and governmental measures and devices which are designed to "protect" particular groups from competition, domestic or international. And I tried to spell out at some length how these other instruments could and should operate. I have already exhausted my assigned time and your patience; so I will only close by stressing the point which is so obvious yet so important about President Nixon's new economic policy. It is that the new policy is only a start—the opening of a door—which could lead to a healthier, more rewarding economy than the one which we have been experiencing. In almost every aspect of the program, success will depend not on what has been done so far but on steps still to be taken.

In the area of inflation control, the immediate next step must be to replace the freeze with an effective incomes policy. But, beyond that, an incomes policy must be buttressed by a whole range of further institutional changes. Some of these necessary changes will be as difficult to accomplish as the design and acceptance of an effective incomes policy. I hope that some of them will be on this committee's agenda for future hearings.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Ackley. I think this is a remarkably fine statement. I am most impressed. I understand you had to put it together in a very short time, but one of the reasons for its excellence, I am sure, is your very extensive background in this area. I think you have done a fine job. It is balanced and it is fair and it is most constructive. I think it is so useful to have you concentrate heavily, as you do, on what we should do in the future because this does provide a very important role for Congress as you indicated in your statement. Legislation is likely to be required here, and I think it is most vital that we have this kind of timely advice before the President comes in with his proposals, and that we have it from someone like you who can speak with such authority and experience.

You seem to assume that the freeze itself is going to be effective. You are the first witness we have had who has made the assumption as clearly and as flatly as you have. I take it you think for the 90-day period there will be very, very little increase in the cost of living. Is that a fair conclusion?

Mr. ACKLEY. That is my view, Mr. Chairman. Very little could mean an annual rate of increase of 1 percent or a half percent, or I suppose one and a half percent. There are some things not covered by the freeze; but, at the moment, agricultural prices are not rising. There will be the passing on of the import surcharge, and so on. There will not be absolute stability; but I think there will be effective stability of most prices.

Chairman PROXMIRE. One of the reasons why I think that assurances are so important is because one of the objections that is given by labor is enforcement of prices is not effective at all. Yesterday we had General Lincoln and Mr. Weber before us and they agreed the system of enforcement is limited, the staff is much smaller than ever before, infinitesimal compared to what we had before. It does rely a great deal on voluntary cooperation and you don't have the kind of discipline that many people feel is essential if you want to police prices.

But you say it will work very, very generally and it is most encouraging.

Mr. Ackley. My judgment depends in part on the proposition that we are not in a situation of excess demand. Individual prices have been rising mostly because other prices have been rising. If we can stop that spiral, as we do with the freeze, I think we take off most of the pressure for current increases in other prices. This is why I believe that comparisons with previous control situations—in which we have had heavy excess demand—are not appropriate.

On the other hand, I would certainly agree that the freeze is not enforceable; and, when and if serious pressures develop against it, it would spring a lot of leaks.

Chairman Proxmire. Although you don't devote much of your statement to this, you seem to come down on the side of being opposed to profit controls, feeling they are unnecessary, we shouldn't have them. How can the system appear to be fair? How can it be fair to organized labor? They protested so vigorously on this and you emphasize over and over again it must give the appearance as well as the reality of fairness. How can we convince labor there is fairness if there are no controls on profits?

Mr. Ackley. I read Mr. Meany's piece in the paper this morning with a great deal of sympathy for his viewpoint. Almost everything he said is correct and relevant. It is just that I don't accept all of his conclusions.

Chairman Proxmire. I read that, too. I ask unanimous consent that that article, which is a short one, be included in the record at this point.

(The article referred to follows:)

[From the New York Times, Aug. 31, 1971]

LABOR'S CASE FOR A PROFITS FREEZE

(By George Meany)

The trade-union movement's indictment of President Nixon's new economic policy rests squarely on one fact: it is demonstrably unfair.

The freeze on wages is absolute. Equity, economic justice, individual hardship—none is deemed worthy of exception. Employers will obviously serve willingly as voluntary policemen to enforce the wage freeze.

In contrast, the freeze on prices is quite ineffective. No systematic enforcement procedure is provided except individual complaints which the Government is currently filing and forgetting. Few, if any, seem destined to reach the courts.

Question and answer sheets from the Cost of Living Council and verbal responses to telephone queries to the Office of Emergency Preparedness hardly constitute enforcement.

A Presidential wish is all that controls dividends. Even corporations that heed the wish can pay increased dividends retroactively after the ninety days. Workers, however, are prohibited from negotiating retroactive wage increases for the ninety-day period.

The President refuses to put a ceiling on interest rates, again ignoring the powers he has had since December, 1969, even though interest rates have contributed substantially to inflation and in fact, under his Administration, hit a 100-year high.

Stock prices are uncontrolled even though they are a "transaction" under the terms of the President's executive order. Fortunes were literally made and taken on the stock market immediately after the President's speech.

The additional tax reduction for business, proposed by the President, is grossly unfair to the average taxpayer, who will receive no comparable benefit. The investment tax credit will cost the Federal treasury $4 billion a year, in addition to three to five billion dollars the Administration gave business last January through accelerated depreciation allowances.

Who will pay for this Federal subsidy of corporate profits? The poor, through delay of much-needed welfare reform; financially strapped cities and states, who will not receive promised Federal help: Federal employees through a 5 per cent slash in employment and a 10½-month wait for a pay raise they have earned and been guaranteed.

The President took no steps to control profits, although simple justice would be served by an excess-profits tax. Profits will certainly increase during the freeze for business generally has already increased prices to cover deferred wage increases due their employees under existing contracts. The freeze now bars those wage increases, so the employers' profits are increasing by million-dollar jumps.

It was patently deceitful for the President to describe his tax measure as a job-creating proposal. There is no evidence at all that tax credits to business will improve employment and abundant experience that industry will once again purchase sophisticated machinery that will eliminate jobs.

The President could have expanded the economy and increased jobs by putting money into the hands of people who would spend it—the unemployed, the workers, the poor and the aged now on Social Security.

All of his recent actions, on top of two-and-a-half years of policies which created massive unemployment and increased inflation, have caused the trade-union movement to finally state publicly that we have lost confidence in the ability of the President to successfully manage the economy.

It is difficult, indeed, to repose confidence in a President who changes courses 180 degrees and fails to acknowledge the reason for that change: the failure of his previous economic game plan.

We in the A.F.L.-C.I.O. have not changed our position.

We will cooperate with economic controls, if the President deems they are necessary, provided they are fair, equal and across-the-board. We will not cooperate with anything less.

If one sector of the economy is asked to sacrifice, then all must sacrifice. This means control on all costs, all prices and all forms of income—profits, stocks, interest rates, dividends and executive compensation as well as workers' wages and salaries.

Where does America go from here? Since the President is not confiding in the people of the United States, no one knows what is being planned.

If it is another stunt, we will oppose it.

If it is equitable and fair, we will cooperate.

We do not think fairness and equity are too much to ask of the President of the United States.

Mr. Ackley. I think it is an excellent statement. He makes a number of points cogently and correctly. I certainly agree that the total program of the President is not a balanced program, and I support very strongly the view expressed by Professor Heller, for example, and other witnesses before this committee, on the need to change the proposed fiscal program to make it not only effective but also fair and equitable. I certainly would fully agree that whatever program replaces the freeze can only work if it bears with reasonable equity on all interest groups, and causes the sacrifices as well as the benefits of stopping inflation to be fairly distributed.

But I think that the call for a profits freeze is a mistaken one. Let's distinguish first between aggregate incomes—that is, aggregate profits or aggregate total payrolls—on the one hand, and wage rates or profit rates, or profit margins or markups, on the other. Labor's aggregate income was not frozen by the freeze but only wage rates, and it seems to me obviously inappropriate to say that, if you freeze wage rates, you must freeze total profits.

Chairman Proxmire. You say labor's income is not frozen because they may work longer hours and may get overtime pay, and so forth, so their weekly income could go up and you expect will go up; is that right?

Mr. ACKLEY. Yes; as the economy expands, aggregate profits are going to rise just as aggregate wages are going to rise.

Now, as a share of the national income, corporate profits today happen to be the lowest they have been in the whole postwar period. Actually aggregate profits, if you look up the numbers, are considerably down from 1968 while aggregate wages and salaries are up roughly 25 percent.

Now, as the economy expands—and we all want it to expand, and I think it is going to expand—aggregate profits are going to rise absolutely and payrolls are obviously going to rise absolutely. But I think that profits will, and ought to, and should, be expected to rise even relatively because they have been depressed—because they are a cyclically volatile share—as opposed to wages.

Chairman PROXMIRE. But they are only depressed as compared to the very high level they reached a couple of years ago. Historically and on the basis of what has happened over the last decade they are still high, are they not, and the last quarter they went up substantially?

Mr. ACKLEY. I think one can only talk about profits relative to the size of the gross national product, or, if you wish, relative to the total amount of investment in the economy. As a share of corporate gross product, corporate profits are a lower percentage than any time since those figures began to be collected, which is 1946.

Now, if profits rise as a share—as well as absolutely—as the economy expands, that does not mean by itself that the restraint system is unfair. The real requirement, it seems to me, is that profits don't rise relative to wages as a result of the widening of profit margins or markups, and this is the function of a restraint program. That is, the restraint on prices should be such as to attempt to avoid any expansion of profits relative to wages simply as a result of the widening of markups over direct costs—that is, of gross profit margins.

Now, if the system works reasonably well, then it seems to me there is no reason for complaint. But it may not, and I think that is what worries labor, and properly so. If it does not work equitably and can't be fixed up so that it does work equitably, then I think we should consider other ways to secure equity in the total program.

Now, so far as I know, taxes are the only other way. But I would warn that an excess profits tax, which has come into recent discussion, does not seem to me to be the way to do it. The excess profits tax is a lousy tax. It is full of inequities as between firms that are in essentially similar positions, and have similar merits. It seems to me that the only excuse for an excess profits tax as such is when there has been a very sharp shift in aggregate demand—for example, as occurs in wartime—so that tremendous windfall profits are being accumulated in certain sectors of industry—not just that aggregate profits are rising, but that their distribution is also becoming unfair. If the restraint program can't be made equitable—and I think it can, and I would hope it can—then I would simply prefer a straight increase in the corporate profits tax rate to an excess profits tax. Or, better still, going after some of the inequities in the tax system, such as capital gains taxation. But I sympathize fully with the objective which Mr. Meany so properly expresses: that the burdens of the total program need to fall equitably upon all segments, and in particular on profits as well as on wages.

I think we exaggerate the extent to which the control of inflation imposes a burden, however, Mr. Chairman. If we can stop inflation we are not going to reduce any sector's real incomes. But we are going to have a healthier economy, in which all sectors will find their income gains more secure and more meaningful.

Chairman PROXMIRE. I take it that part of your answer, too—and your answer is most helpful—is that you would modify the fiscal package recommended by the administration which would by itself sharply increase profits, in part increasing windfall profits, but I would like also to ask you to comment on the proposals that you seem to favor, supporting Mr. Heller's position, which would give us a substantial, I believe a substantial, full employment deficit if followed through. You say we have to stimulate the economy more. I am sympathetic with that and I think it is important if we are going to get compliance with this freeze and with what follows after it, that we stimulate the economy as much as we can.

On the other hand, if you do that they feel you will create a full-employment deficit which will have inflationary implications similar to the kinds of problem we had, with which you are so familiar, in the late 1960's.

Mr. ACKLEY. Well, I don't think that anyone should be frightened by full-employment deficits when they occur at the right time. I think it is very proper to seek a full-employment deficit at a time like this, to assure that the economy expands. There is lots of room for expansion—something like a $70-billion gap between our gross national product and what we could produce at full employment. The economy is not strong. The midsummer economy, prior to the President's program, was not booming. There is no evidence of sharp expansion. There is lots of room for expansion, and we need it. Thus, a stimulative fiscal policy is certainly an important need.

What should be the nature of the policy? It seems to me there are two things wrong with the President's proposals here. One is that the total policy is not sufficiently stimulative, and I would like to make it more so; and, second, it is the wrong kind of a stimulative program.

If you want my views in detail I would be glad to talk about the specific tax proposals but, as I have already said, I largely associate myself with Mr. Heller's views on this.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman. I am interested in your views on that. Apparently a $20-billion deficit in prospect for next year is not enough. How much do you think it ought to be?

Mr. ACKLEY. Well, that is the kind of a question that can only be answered in the context of a detailed forecast of aggregate demand and all the rest.

Representative CONABLE. What do you think a more stimulative approach ought to be based on, further Government spending or on greater tax relief for individuals?

Mr. ACKLEY. In my view the criteria for choice of a stimulative program ought to include several things: first, it ought to be relatively balanced between consumers and business; second, so far as possible what we do to stimulate the economy now should not permanently reduce the revenue capacity of our tax system or permanently increase the necessary level of expenditures——

Representative CONABLE. Excuse me, sir; what do you mean by that? Do you mean, for instance, we should not increase the personal exemptions because that will have a permanent impact on the revenue capacity of the tax system, that sort of thing?

Mr. ACKLEY. The increase in the standard deduction and the exemption are already legislated; they go into effect in 1972 and 1973 in any case. In effect, we have lost that. Speeding that up to January 1972 does not permanently reduce the capacity of the system.

Representative CONABLE. But, for instance, you would not increase the personal exemptions beyond what is already in the law because that would have a permanent impact on the revenue-raising capacity of the Government?

Mr. ACKLEY. I would be opposed to that, yes. There are other things we can do, of course. We can, for example, delay the scheduled and the recommended increases in payroll taxes which are supposed to go into effect on January 1, 1972. We can delay those, but ultimately make them. We have not then permanently lost any revenue-producing capacity.

Representative CONABLE. That would have a dual effect? It would substantially reduce the Government's revenue while increasing the spendable income on the part of the payroll taxpayers?

Mr. ACKLEY. Right.

On the expenditure side I would similarly like to do things that give stimulus currently when it is needed, but don't put permanent or even extended burdens on our expenditure requirements once we get back to full employment. This is one reason why I would be strongly opposed to a public works program. We had an emergency public works program in 1962 which was supposed to stimulate recovery. Well, the figures which were recently published by Arthur Okun of the Brookings Institution show that a large part of those expenditures were made not while we were recovering from the recession, but in 1965, 1966, and 1967, when they were exactly what we didn't need.

So I would like to concentrate on a stimulative program that gives immediate stimulus, but gives us the flexibility to meet the requirements in the future as those arise.

Representative CONABLE. Isn't it true though that regardless of whether or not the stimulation is justified any additional stimulation increases the uncertainty of the effectiveness of the incomes restraint on the other side? The uncertainties are certainly going to be enhanced if there is additional upward pressure on wages and prices.

Mr. ACKLEY. Yes, indeed; I think that is entirely correct.

My view is that under present circumstances, with the volume of unused resources that we have today, the inflationary problem does not arise, has not arisen, will not in the near future arise from having too much demand. We are worried about inflation because of the inflation we already have. Our need for new restraints on prices is to reduce the rate of inflation we already have, not because there is immediate danger of having too much demand as the economy recovers, which will create new inflationary pressures.

Representative CONABLE. May I ask you further to clarify your position on any possible wage-price review board? I noticed that you say at one point that there must be greater involvement of the various

sectors of the economy in setting up any such device, "It cannot be solved by one mass meeting in the East Room," you said.

Then later on you say it is not your view that the panel of distinguished citizens serving as a wage-price review board should serve as representatives of specific interest groups. There seems to be a certain degree of inconsistency there. You apparently want them detached from the interests involved but you want the interests involved very much consulted in setting them up. Is that a fair statement of your position?

Mr. ACKLEY. Yes.

Representative CONABLE. And why do you want to keep representatives of labor and business off any wage-price review board?

Mr. ACKLEY. I suppose this is a private view of mine that tripartite boards do not function highly effectively. I would hope that any wage-price review board, if you wanted to go that way, would be broadly representative of all interests of society; that it would include people who are associated with the labor movement or have been associated with it, people who have been associated with big business, and with other interests. But I would not have them serve as representatives of labor and of business. I think that is a vital distinction. The tripartite board is one in which most votes are really 2 to 1.

Representative CONABLE. Locked in.

Mr. ACKLEY. And it is almost automatic that the labor man votes for the labor position and the businessman votes for the management position, and the decision is in effect made by the public member or members. I would like all members to be public members.

In the consultation process by which the program is designed, through which it is accepted and its tolerance is sought to be achieved, clearly one has to consult interest groups as such, and whatever spokesmen for these interests are available. But I think that is quite different from the nature of the administration of the system once it is in effect. I don't think it is crucial, but I have a strong personal preference opposed to tripartitism. After all, there are more than three interests, anyway.

Representative CONABLE. And the public interest probably should predominate in any event, should it not?

Mr. ACKLEY. I would hope so.

Representative CONABLE. I notice in your "Stemming World Inflation" statement at one point you said:

> We have to recognize that inflation is not purely an economic phenomenon. In every country there are significant institutional, psychological and attitudinal factors which heavily influence the responses of individuals and groups to the objective economic circumstances.

Now, it sounds to me from this as though you are referring perhaps to the polarization that is afflicting our economic community as well as all our other communities. For instance, in labor we have had the spectacle of labor leaders trying to make in some cases what they consider to be reasonable settlements reflecting their responsibilities, only to see the membership reject those recommendations almost out of hand. In other words, we find in the economic community some of the same militant reactions that are occurring in social groups and in the political life of our country. From this it seems to me you are suggesting whatever we do in the future it is going to have to be coupled with

a high degree of political leadership, appeals to patriotism, with this sort of jawboning, which seeks to overcome the polarization which afflicts us. Is that a fair conclusion?

Mr. ACKLEY. Yes, I think it is a very fair conclusion. I believe that in my "Stemming World Inflation" I referred even somewhat more specifically to the situation which you describe. For example, I find that on page 53 I referred to "the increasing aspirations of every group in our society for rapidly rising real incomes, and the tendency everywhere for the fulfillment of people's aspirations—in all areas of economic, political, and social life—to be pressed ever more aggressively and insistently. In particular, in a number of countries in recent years, there appears to have developed an increased aggressiveness, a growing truculence, with which groups of all kind are pressing their claims for what they regard as their rightful shares of the national income—shares which often add up to more than 100 percent. To some extent, this new truculence may be the product of inflation, not its cause. Nevertheless, it may also represent the expression, in the marketplace, of a broader social and political trend in Western society."

I do believe we face today, and in some ways regret it, this polarization to which you refer. I find that some sociological explanation of inflation is almost an essential part of it. I don't fully understand why there has been the change, for example, in the attitudes of the teachers or the policemen toward the way in which they go about getting what they think is due to them.

Representative CONABLE. But as an economist apparently you consider this a substantial factor in our current problems?

Mr. ACKLEY. I do indeed. I think you can, for example, look at the experience of France in 1968. It suffered severe inflation from a wage explosion that had no clear economic explanation. It was an outburst of rage, indignation, discontent against the existing situation. The same thing happened in Italy in 1969.

I think some of the things we see today in the United States represent a similar type of response, and that this is contributing to our problems.

Representative CONABLE. In this sense then a purely statistical analysis simply is not enough. There is a call for high leadership.

Let me say, sir, I think your statement is an excellent one. In laying out the possibilities open to us following the freeze you have helped us a good deal and I hope that the Congress will respond in an affirmative, positive way to the initiative the President has taken here so that the Nation will get the kind of leadership it needs in this economic area.

Chairman PROXMIRE. Mr. Ackley, I think it is most interesting the position that you have taken; the position Mr. Heller took is one of not controlling profits, not controlling compensations of capital and the feeling that to do so would be a mistake.

The position undertaken, I understand, by Mr. Stans, the Secretary of Commerce, and Mr. Hodgson, the present administration Secretary of Labor, has been we ought to look at the profits control and perhaps that will be necessary or desirable.

It is also interesting to me that during your tenure as Chairman of the Council of Economic Advisers, and that of Mr. Heller, profits increased and increased substantially. It was one of the biggest increases

I think in all history. While, during the present administration's tenure in office, profits have dropped.

I wonder who is on whose side? I don't know whether you fellows are overcompensating for being called antibusiness. I am sure it is based on a careful expert economic analysis on your part.

Let me get at the analysis you put in your fine book, "Stemming World Inflation," when you analyzed what we really need in guideposts in a somewhat different way than you do here. You say, as you did in your statement, No. 1:

A principal weakness of the 1962–1966 "guideposts" was the failure sufficiently to involve the leadership of labor, business, and public opinion.

Congressman Conable has called your attention to one inconsistency. I would like to call your attention to another. You say, "But the freeze," in your statement, "should surely be suspended on November 14 for all prices at retail (except possibly a few big-ticket items), all rents, all personal services," I take it that would include medical services, "wage rates in low-wage industries, and as much else," and so forth. It seems to me with that kind of program you would have a very difficult time winning or holding the cooperation of organized labor. If we say we are not going to freeze rents, we are not going to freeze prices at retail but we are going to continue to have controls on your compensation, it would be very difficult, it would seem to me, for any leader of organized labor to hold his people in line even if he would support that position.

Mr. Ackley. I think you are right that it will be very difficult to convince all segments of the public and all of the interest groups that any program is going to be both fair and effective.

I think the only way you can guarantee effective stabilization of the prices of items such as in the list which you have just read is through a control system, a comprehensive controls system, of the sort that it seems to me we must not let ourselves get into the habit of using.

If under circumstances like this, with nearly 6 percent unemployment—and it is not going to get down below 5 percent by the end of 1972 at least—if we cannot stabilize prices without having an across-the-board price control on all retail prices and all personal services and rents, then there is no circumstance in the future that I can think of when we are going to be able to do it. I just don't want to live in an economy that is subject to comprehensive, continuing, permanent price controls. It is a different kind of world than we know, and I think it is the kind of world none of us would like to live in very long.

Direct controls are very popular when they are not in effect. But, once they are in effect, it doesn't take very long for everybody to find out all those things that are wrong with them. I think going down that road is just the wrong road.

Chairman Proxmire. Haven't the labor people specifically spoken out? I was on a panel out in California a few days ago with Nat Goldfinger and Nat Goldfinger said they wanted complete across-the-board controls if they were going to cooperate, and I think in that Meany letter which we have put in the record that President Meany called for the same kind of thing.

They will do it provided, they say, that everything is limited in the same way. They don't want to be the exception, and I think what you are proposing really is to make labor pretty much the exception, de-

controlling almost everything else except the prices by some of the big corporations at wholesale or at the manufacturing level.

Mr. ACKLEY. I think what labor requires, and properly requires, is a system which effectively restrains price increases to the same extent that it effectively restrains wage increases. That will be difficult, but it has got to be something other than comprehensive wage-price controls. I don't think labor would like that any better than the rest of us. I believe that such a system can be designed. The absence of detailed price controls at retail or detailed controls on rents did not prevent the Consumer Price Index from being essentially stable from 1961 through 1965. It didn't prevent rents from staying down. After all, there is competition in the economy. What we have got to avoid are those events, including those mistakes of policy, which kick off a spiral which can then perpetuate itself. Once we get the present spiral under control, I think that with proper fiscal and monetary policies—and with the other things we are going to have to do—we can maintain a reasonable degree of stability without comprehensive controls of prices.

Chairman PROXMIRE. What disturbs me then is your second point; you go on to say the "evolution of the guideposts placed too much stress on economic rationality as opposed to workability and acceptance."

It seems to me those guideposts finally collapsed in 1966; the immediate proximate cause, I guess, was the airline settlement; is that correct?

Mr. ACKLEY. I don't think there is any single element.

Chairman PROXMIRE. In addition there were other elements involved here but I think you could be faulted perhaps for what happened by the system not being sufficiently comprehensive or firm rather than not being flexible enough.

Mr. ACKLEY. You can analyze what happened then in any of several ways.

You can say that if we had been willing to go to comprehensive controls, with full legal sanctions, we might have stabilized the price level even though we had a very bad fiscal policy. I prefer to say we had a very bad fiscal policy, and that no system of basically voluntary wage-price restraints could be strong enough to stand up against the pressures that were put on it. We could have had a better restraint system, too; but it was basically the bad fiscal policy which caused the guideposts to collapse.

In the language you read, I suppose that I am suggesting that, for example, in January 1966, when it came time to decide whether the wage guidepost ought to be again set at precisely 3.2 percent, that we would have been better off if we had listened a little more to the reasons why that was judged to be inappropriate or unfair; if we had given a little bit on that, and thereby recognized a little more inflation, the guidepost policy might in the end have proved more viable.

Chairman PROXMIRE. Let's follow up on that a little bit. Mr. Charles Schultze suggested to us that we might like what you had in that period, that is a wage guideline based on productivity increases plus, he would suggest, about half the increase in the cost of living in the preceding year. Would you feel that that would be a fair principle to proceed on?

Mr. ACKLEY. That was a proposal we frequently discussed in the later 1960's, when we were trying to decide whether or how to doctor up the guideposts to take account of the fact price stability had already been impaired. I think it may have been a good principle then. I am not convinced it is a good principle today, because it seems to me what we ought to be shooting for is not something which merely takes into account what has been happening to the cost of living, but rather what our system of restraints is going to accomplish. If these are going to be be effective, then we don't have to build in the assumption that price increases are going to continue at the same rate they have been in the past, and that we should compensate for even one-half of what has been the historical increases. We want to aim at getting back to stability. Of course, since this proposal recognizes only half of past inflation, it might come out much the same.

Chairman PROXMIRE. Mr. Schultze argues that would get us back gradually over time.

Mr. ACKLEY. Gradually.

Chairman PROXMIRE. And would be a more flexible principle than you had before. You would agree you have to have, should have, productivity as the basic principle involved in setting the wage-price guidelines?

Mr. ACKLEY. Whatever you seek to achieve regarding the general price level, I don't see how you can get away from tying wage increases in some way to productivity, even if you are going to allow wage increases in excess of productivity. But if you want price stability, wage increases can't average much more than average productivity.

Chairman PROXMIRE. Then you would say that productivity has to be the basis?

Mr. ACKLEY. Yes.

Chairman PROXMIRE. You can't get away from it.

Mr. ACKLEY. But you don't have to build a system aimed at perfect stability when you know you are not going to have it.

Chairman PROXMIRE. Well, yes, but what you are saying is productivity must be the fundamental basis for it and then make whatever allowances the practical situation requires; is that right?

Mr. ACKLEY. I don't think anyone has ever come up with an alternative principle that makes any sense.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Mr. Ackley, I would like to ask you a little further about the relative role of the Congress and the Presidency in this economic situation. You come before us not only as an economist but as a man who has had a good deal of experience in Government. You had, I think, quite a few unhappy experiences in your dealings with the Congress as chairman of the Council of Economic Advisers during the period on which we now look back as a period of economic disaster. In all fairness you did request additional taxes, the Congress was reluctant to impose them. We had a $25 billion deficit at a time of full employment; and I note your reluctance to talk about the causes of inflation, emphasizing instead the things that continue to feed it later on in this particular context. Now it is quite obvious that you are here advising us as so-called economic advisers to the Congress, and that you have no particular reason to be sanguine about Congress' inclination to take economic advice in the light of political realities,

including a very firm stand by organized labor on the particular proposals the President has made.

I would just like to get your view of how you think the relative roles of the Congress and the Presidency are going to emerge here as we go down the pike? You say yourself that the freeze is probably not as significant as what follows the freeze, although you say the freeze can be a valuable first step if we build on it wisely.

Now, in all probability there is going to be an increasing role for legislation here, is there not, as we go along? What do you see as the big pitfall in the new economic program, proposed by the President, and what do you think the role of Congress is likely to be before we get through? Is it possible for it to be the kind of objective, constructive role that you are calling for here?

Mr. Ackley. Well, Mr. Conable, I rather doubt that I can throw much light on these most important questions. I do happen to believe that the quality of public discussion, and of congressional discussion and congressional action in economic affairs, is steadily improving. The nature of the discourse is better now than it was 5 years ago or infinitely better than it was 10 years ago.

I do feel that, in some areas of economic policymaking, some new congressional arrangements may be essential to doing a better job. For example, in the making of fiscal policy, it does seem to me that we don't have adequate machinery which permits the Congress to focus on the question of what the proper fiscal policy should be. We have dozens of appropriations committees that look at little pieces of the budget and make recommendations which are passed individually, with nobody really controlling what the total is going to be. The tax actions are taken by another set of committees. There is no place where the Congress can look at the whole fiscal program proposed by the President, and conclude either that we like it and we are going to try to adopt it; or that we don't like it and we are going to adopt another one; and that some other specific program is the kind of total fiscal program that is needed, and then to adopt it. There just isn't any congressional machinery that provides for reading such conclusions. I don't quite know what that kind of machinery would be. Of course, this committee in a sense helps perform that function; but it is not a direct part of the legislative process.

In the immediate situation ahead, I worry a little bit about how the Congress may respond to what is becoming, I think, a general recognition that the President's tax program is unbalanced. It gives a double dip to business, by putting the investment tax credit on top of a very generous depreciation reform; and it then threatens to add to that a DISC proposal which is still another bonanza for business. What it offers to personal taxpayers is much more modest. I think there is a danger, at least the newspapers tell me there is danger, that Congress will respond to this recognized imbalance simply by cutting personal taxes a lot more. That would get us into the problem that I was talking about a little while ago. I just don't want to see the revenue capacity of our tax system permanently impaired. I prefer to eliminate the double dip for business and to give stimulus in other ways—so far as possible by temporary tax reductions or temporary expenditure increases.

On the wage-price side, I suppose that the possible legislation that Congress might be requested to pass, and might wish to pass, would be legislation establishing authority for some kind of price-wage review board, or similar machinery. I don't know to what extent that kind of machinery could be set up by Executive order, relying on the legislation that already exists. I would think that it probably would require new legislation to be most effective.

I have puzzled a little bit about whether a wage-price review board ought to be a part of the Office of the President or whether it should be really a creation of the Congress and so more directly responsible to the Congress. Should it be on the model of an independent regulatory commission, with members appointed by the President but not removable, let's say, for long terms? I tend to believe that a price-wage review board ought to be responsible to the President in the sense that he ought not only to appoint the members, but to be able to remove them, if he wished.

I would hope that it would be somewhat separate from the Office of the President, and that it would come to have a stature of its own rather that just a reflection of the prestige and the authority of the Presidency.

But these are all difficult questions, on which it seems to me that men like you have much more experience and wisdom than economists.

Chairman PROXMIRE. Mr. Ackley, in discussing the administration of the guideposts, you say the Council of Economic Advisers is not the group to do it. You say that neither the Secretary of Labor nor of Commerce would be suitable.

You say a merger of the two departments which the President contemplated would be an ideal office preferable to that although the merger obviously is not going to be in time to do this.

What does that leave? Do you feel the Secretary of the Treasury would be a logical man to do this inasmuch as he is chairman of the Cost of Living Council?

Mr. ACKLEY. Well, possibly. I think I would prefer a new administration of some kind which does not now exist.

Chairman PROXMIRE. Should that administration include Cabinet officers?

Mr. ACKLEY. I think that it might need some kind of an advisory committee—a board of directors—consisting of Cabinet officers. But I would think it ought to be a new organization with its own head.

Chairman PROXMIRE. And it should be a board consisting of people with broad experience in labor and business but not representing a constituency; is that right?

Mr. ACKLEY. That, I guess, would be my suggestion.

Chairman PROXMIRE. Now, one of the most significant recommendations you have here and pertinent so far as this committee and the Congress are concerned is when you say that, you call for, the establishment "by legislation of a Price-Wage Review Board, with limited powers (*a*) to require prior notice of wage and price changes, (*b*) to suspend such changes for a limited period, (*c*) to investigate them (including power to compel testimony), and (*d*) to report to the public with recommendations."

Do you still stand by that recommendation in the light of the changed situation which the President's new economic program has given us? This, of course, was written substantially before that.

Mr. ACKLEY. It was written before that. Nor did I contemplate the possibility that the powers that I suggest for a wage-price review board might already be available under the other legislation which was passed in April.

Yes, I think that this may be still a useful recommendation. As indicated in my statement, I am not ready to come down in favor of a specific plan at this point. I think it is a matter that requires a lot of public discussion; and partly it depends on how labor and business feel about it.

Chairman PROXMIRE. Of course, one of the reasons for having these hearings at this time is so that as this emerges, the administration will be in a much better position to evaluate it.

Mr. ACKLEY. Exactly.

Chairman PROXMIRE. Let me get into the specifies a little bit. When you say "prior notice," 30 days' notice in advance of an increase in wages or increase in prices?

Mr. ACKLEY. I haven't really thought about that, Mr. Chairman. That would certainly be adequate, I would think. Perhaps less is needed.

Chairman PROXMIRE. The purpose of it is to give the President an opportunity to act, I presume.

Mr. ACKLEY. You obviously can't require notice by all sellers and of all price increases. You have got to describe those kinds of price increases for which advance notice must be given, otherwise you would have to build two or three Libraries of Congress just to contain the information submitted.

There is a lot of work to be done to make these proposals workable.

Chairman PROXMIRE. Then in your next recommendation you seem to depart from a generally restrained and cautious approach.

You say:

> The President—

But not the Wage-Price Review Board—

> Should have at all times standby authority for the compulsory control of wages and prices, wholly or in any part.

This would give to the President by the Congress an opportunity for any President to invoke a tremendous kind of authority. You say "at all times." I presume you would want permanent legislation by Congress with the authority to review what the President has done by acting with congressional veto. This kind of limits the congressional authority and puts in the President's hand a very, very large amount of power.

Mr. ACKLEY. Mr. Chairman, this is a view I have held for a long time, and I hold it quite firmly. It grows out, I think, of the experience of 1950 when in an emergency situation price control authority did not exist, and there was extended discussion of whether that authority should be provided, and what form it should take. I think that discussion contributed more than everything else to the very rapid inflation that occurred between June 1950 and January 1951.

The time to provide the President with price control authority is not when an inflationary situation is developing. I think he ought to have it at all times. This leaves tremendous power in his hands, and therefore leads to my second suggestion—I am not sure that I suggested this first—other people have surely mentioned it—that whenever he

uses that authority he then becomes immediately accountable to a congressional review. But I believe that he ought to have it so that you don't get into the situation that occurred at the time of the Korean war. I think that, to understand the danger, you have to recognize that any price control has to start with a freeze—there is just no other way to do it, and then you move on from there—whether you are going to have price controls for a long or short period. If you start with a freeze, and there has been extended prior discussion of whether there should be a freeze, prices and wages can just skyrocket while you are talking about it, and then your freeze catches prices and wages that have been deliberately elevated, just to prepare for the freeze. So I really do believe that the President needs standby authority.

Now, as I suggested to this committee in testimony, perhaps a year ago, it is my view that the President probably has enough authority under the Trading with the Enemy Act, perhaps to invoke a freeze even if there were not more specific standby authority.

However, I think it is a lot better for him though to have the specific authority, but then to have to account for any use he makes of it.

Chairman PROXMIRE. Then you also go on to say:

The existence of a price incomes policy—

Although not, obviously, the details of the policy—

Should cease to be considered a partisan issue, but rather come to be regarded as a regular and permanent aspect of the U.S. stabilization system.

So you give the President this power and we make it permanent and, at the same time, you made, I think, the most devastating analysis I have yet seen of John Kenneth Galbraith's proposal for comprehensive permanent controls over large business, and you conclude by saying:

I cannot believe anyone can seriously think through the problems raised by permanent wage-price controls on the heart of our economy and still advocate it.

Now, is there inconsistency here? Are you saying simply the President should have this power but rarely use it and only use it for brief periods? If that is the case it seems to me Congress ought to husband it and give the President the power to provide for a freeze but then itself should determine whether or not this massive power should be extended in any form by the President.

Mr. ACKLEY. I certainly would not contemplate the use of general wage-price control authority except in emergency situations, when there might be need to act exceedingly quickly, and that is why it seems to me the authority ought always to be there.

My view that a price-incomes policy, as opposed to price-wage controls, should come to be regarded as a regular and permanent aspect of the U.S. stabilization system simply reflects my conviction that inflationary pressures are endemic in our kind of society, that we have got, therefore, to use all of the weapons that we have, and that incomes policies are a useful part of that arsenal, by themselves insufficient to combat endemic inflation, but helpful.

Chairman PROXMIRE. Why should there then not be at least a limit on the time during which the President can put this into effect, a year or 6 months or something, because if you are going to make this a permanent policy and then give the President the authority to invoke it only modified by a congressional veto, which usually is pretty hard

for Congress to summon, especially in a period of emergency, then the President could keep it in effect indefinitely. I am not talking about this President, but any President.

Mr. ACKLEY. Of course. It seems to me, first, that we have to clarify two things. The authority, such as it might be, required for a price-wage review board is a very limited authority which, as I have advocated here, does not involve the authority directly to enforce any maximum price or wage. This is quite different from the authority for controls, which I suggest ought to be available on a standby basis but subject to review when it is used. Of course, once it had been used by the President, it could be taken away at any time. I don't see any problem in making the authority for a wage-price review board indefinite; although if Congress wanted to provide that authority only for 1 or 2 years at a time I don't think that would be crucial either. I distinguish quite clearly between the authority to invoke broad scale price-wage controls with legal sanctions, and the authority for a wage-price review board to conduct an incomes policy. These are two quite different things.

Chairman PROXMIRE. Mr. Ackley, how about a very, very practical and immediate problem that must be tremendously bothersome for the Cost of Living Council now. What are you going to do about the contracts that have been signed and affirmed and are in effect to increase wages in the automobile industry, the steel industry, the communications industry, and the trucking industry at regular intervals for the next 3 years? These are, in my view, highly inflationary increases. They are contracts that have been agreed to by labor and by management. In your view is it essential that these be rolled back?

Mr. ACKLEY. I think——

Chairman PROXMIRE. Can they be?

Mr. ACKLEY (continuing). This is close to the nub of the problem of the effectiveness of future stabilization policy, as I tried to suggest. There are two parts to the problem.

One, the deferred wage increases which might exceed whatever standard is imposed for wage increases and, second, the contracts which are expiring and which contain, in a sense, inequities if the catch-up is not permitted.

Of course, we have to decide how quickly we want to try to get back to reasonable stability of prices, and this determines how tough a program we need to have. If we decide that we want to do this quickly, then I think we are going to have to find some way of cutting across deferred increases.

Chairman PROXMIRE. What you are saying then is those deferred increases should not be permitted to go into effect at the time. Some action should be taken by the Federal Government to reduce them to a level which is not as inflationary as they are.

Mr. ACKLEY. My impression is that the second and third year increases in both the automobile and steel contract, for example, are rather modest, and conceivably might fall within the standards that might be promulgated for wage increases.

But there undoubtedly are some second and third year increases in construction contracts, and perhaps many others, that would clearly be inconsistent with the new standards, and I don't see how you can permit those to go into effect.

Chairman PROXMIRE. What you are saying in general is you develop a guideline and then you require that that guideline be lived up to even if there has been a prior contract; is that correct?

Mr. ACKLEY. Of course, yes.

Chairman PROXMIRE. Now you say that Herb Stein should not have a central role in the program, and yet he is in charge of planning phase two. Should he be replaced or does his position in the program invalidate it?

Mr. ACKLEY. Well, that was said somewhat with tongue-in-cheek, Mr. Chairman. I think Herb Stein is a most able economist.

Chairman PROXMIRE. I think he is too, but I think you raise a very legitimate point.

Mr. ACKLEY. I think that he cannot have a very effective role in a position which involves the very direction of the program, the effort to secure its acceptance——

Chairman PROXMIRE. It is more than a tongue-in-cheek expression as I get it here. You say:

"Those trying to lead must have conviction that what they are trying to do is feasible and worth doing. This is why the Herb Steins and the George Shultzes must not have central roles in the program."

And certainly planning phase two is a central role, perhaps one of the two or three most important roles, involved here.

Mr. ACKLEY. I think there is a distinction to be made between the technical work required in planning a program, and setting up alternatives and costing them out, and the political leadership and political decisionmaking that must be involved. It is the latter that must fall to someone else.

Chairman PROXMIRE. The President is the only one who can do that. But Stein certainly has as important a staff role as anybody in the administration.

Mr. ACKLEY. I guess what I am saying if we were setting up a wage-price review board, we should not have Herb Stein or George Shultz as the chairman of it. I don't think they would want to anyway.

Chairman PROXMIRE. Would you retract your statement about Stein being in charge of phase two, because the implications are he shouldn't be?

Mr. ACKLEY. No; I didn't mean to imply that the staff work he is doing is inappropriately being done by him. I am suggesting that once the staff work is done somebody else ought to be in charge.

Chairman PROXMIRE. Isn't that staff work right at the heart of it, right at the heart of it? I have a great deal of admiration and respect for Mr. Stein. He is intelligent, he is a very able economist but if we can accept what you say here that people who are in charge of this program should have convictions that it will work, and Stein has said over and over again that it won't work; should he be in charge of setting it up? That is what he is doing, I think that is perhaps a more important role than administering.

Mr. ACKLEY. I don't really think that is the case, Mr. Chairman. I think the head of any stabilization effort has got to be a political man and not an economist. Ken Galbraith was a fairly effective head of OPA for a while—or at least the head of the price side—but Ken never was just an economist——

Chairman PROXMIRE. You were Ambassador to Italy. That is more of a political than economic assignment.

Mr. ACKLEY. Really, I didn't mean to imply that Herb ought not to be able to do exceedingly effective and useful staff work in outlining the alternatives and preparing plans.

Chairman PROXMIRE. Let me ask you one other question because I can't resist asking it although it was not a central part of your presentation.

This deals with the international situation. We have a situation where the administration has cut the dollar loose from gold and permitted it to float and we assume this will give us perhaps an 8- to 10-percent advantage in our trade. No. 2, the administration has announced a surtax in addition to that of 10 percent.

No. 3, they provide for an investment credit which will only apply, for the first time only apply, to equipment bought in this country and not bought abroad which gives, of course, an additional advantage, these are cascading advantages.

And then, No. 4, of course, you have DISC, the program to subsidize exports.

Now do we need this agglomeration of advantage for American-built, American-made products?

Is this the beginning of a protectionist policy? Would you recommend that at least some of these programs be changed, eliminated?

Mr. ACKLEY. Well, I hope it is not the beginning of a wave of protectionism, and the possible development of an international trade war among the nations.

I think that several parts of this have to be considered separately. The 10-percent import surcharge, I hope the Congress will insist, should come off once the initial parity adjustments have been made. That is what it is designed for; it has no permanent place——

Chairman PROXMIRE. By and large that is a hope because, as you know, our Presidents, including President Nixon, have been far more interested in international trade and in fair international dealing than the Congress has been.

We in Congress are much more attuned to our own constituencies. We are interested in protecting the people in our States, and if the President does not give leadership in this area there is not much hope for moving ahead. I doubt Congress will act unless the President recommends action. He might but it would be most unusual.

Mr. ACKLEY. The President certainly has made very clear his purpose in having this surcharge as temporary; and, if the Congress can't, I hope that the public will hold him to that intention.

The feature in the proposed investment tax credit to which you refer was one of which I was first aware in reading this morning's paper. I had not realized it had been proposed that way.

Chairman PROXMIRE. We just discovered it yesterday. I asked the staff about it and they inquired and found out it was the first time confined to American products.

Mr. ACKLEY. My initial judgment is that this is a most unfortunate proposal, and I would hope that it would not be passed in this form.

Chairman PROXMIRE. DISC was the other one, subsidizing exports.

Mr. ACKLEY. DISC I feel is probably not very effective in promoting exports but probably quite effective in reducing corporate taxes. As part of the total tax package of the administration, it contributes notably to its imbalance. I would oppose it.

Chairman PROXMIRE. Well, Mr. Ackley, I want to thank you very much. You have done an excellent job, one of the most useful presentations we have had in a long time, a very fine analysis of the President's program.

Tomorrow the committee will reconvene at 10 a.m. in this room to hear Mr. Arthur Okun and Mr. Edward Bernstein.

(Whereupon, at 12:35 p.m., the committee was adjourned, to reconvene at 10 a.m., Wednesday, September 1, 1971.)

THE PRESIDENT'S NEW ECONOMIC PROGRAM

WEDNESDAY, SEPTEMBER 1, 1971

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire and Representative Conable.

Also present: James W. Knowles, director of research; Loughlin F. McHugh, senior economist; Richard F. Kaufman and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig and Leslie J. Bander, economists for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

This morning we are continuing our hearings on the administration's new economic program. Our witnesses are two very distinguished economists and former Government officials Mr. Arthur Okun and Mr. Edward Bernstein.

The most important question about the President's new program is the question of what will follow the current temporary measures. The administration has not yet unveiled their views on what should come next. Indeed, they have not made it entirely clear what procedures they will use for developing more permanent policies. Expert witnesses appearing before this committee have stressed the importance of beginning immediately to involve all major groups in our economy in a cooperative effort for working out "phase 2." They have also made many valuable suggestions relating to the substance of a longer term price-wage policy. Yesterday, for example, Mr. Gardner Ackley described with great clarity four possible variants of price-wage policy and commented on the promises and pitfalls of each.

This morning our first witness, Mr. Arthur Okun, is a man with similar credentials of expertise and experience in the administration and evaluation of price-wage policy. As a member and then Chairman of the Council of Economic Advisers and as a member of President Johnson's Cabinet Committee on Price Stability, Mr. Okun gained experience with guideposts, with jawboning, and with the whole range of Government actions which can influence price stability. I just checked with Mr. Okun and discovered that his doctoral dissertation, and the dissertation usually has a profound effect on the subsequent

activity of scholars, was on inflation, and was a very significant and a valuable contribution in the area of understanding of inflation and psychological reaction of consumers.

More recently as a senior fellow at the Brookings Institution, Mr. Okun has studied the impact of the guideposts and has concluded that they did indeed have a salutary effect during the first half of the 1960's.

Our second witness this morning is Mr. Edward M. Bernstein. Until now, our attention has been focused primarily on the domestic aspects of the President's economic program, but the international aspects are equally, if not more, important. Mr. Bernstein's reputation as an international economist and his participation at the Bretton Woods Conference that established the present international monetary system make him uniquely qualified to evaluate these international aspects. Mr. Bernstein, after receiving his Ph. D. from Harvard, taught and worked as an economist with the Department of the Treasury. In 1944, he was the chief technical adviser and executive secretary to the U.S. delegation at Bretton Woods. He later served as Director of Research at the International Monetary Fund and is now president of his own research firm, EMB Limited.

Mr. Okun, will you proceed? We have had some change of plans with regard to the presentation but we finally concluded that probably it would be best to have both Mr. Okun and Mr. Bernstein proceed and then we will question both of them because there is some overlap and there might be some interesting and useful dialogue between these two eminent scholars.

Mr. Okun, you go right ahead.

STATEMENT OF ARTHUR M. OKUN, SENIOR FELLOW, THE BROOKINGS INSTITUTION[1]

Mr. Okun. Thank you, Mr. Chairman.

Whatever the longer run and more far-reaching consequences of the program the President outlined to the Nation on August 15, it has created an immediate boom in the demand for the words, and hopefully, the wisdom, of economists. It has unleased an unprecedented volume of discussion, analysis, and debate. Some of the most illuminating dialog has already taken place before this committee, and hence I feel relieved of any responsibility for a compehensive coverage of all aspects and issues in the program. Rather, I will take advantage of the privilege of your invitation to get some particular thoughts off my chest.

On the whole, the President's program has markedly improved our opportunities to get on the path of noninflationary prosperity. As I will emphasize, however, it offers opportunities—rather than solutions. Viewing the program's three basic parts—the wage-price, international, and fiscal components—I will offer two cheers. I am in general agreement with the wage-price and international initiatives and will focus on the need for follow-through, particularly for an effective and equitable phase two price-wage program. In the case of the fiscal proposals, however, a drastic overhaul rather than a follow-through is in

[1] The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

order. I shall first turn to the dismal story of the fiscal program and then move on to more cheerful matters.

FISCAL PROPOSALS

All three parts of the President's program have some bearing on the Nation's most urgent economic problem of launching recovery toward full employment. If, as a result of the price-wage measures that follow the freeze, inflation should be significantly reduced during the year ahead, that success will contribute to more production and more jobs by lowering interest rates, facilitating easier credit conditions, rebuilding consumer confidence, and increasing the real purchasing power of pensions and liquid assets. If the international program restores our net export surplus, that too will add to domestic demand and jobs. Of the three parts, however, the fiscal program was most clearly aimed at job creation and it seems least promising in pursuit of that goal.

STIMULUS?

In the past 2 weeks, the amount of stimulus in the fiscal proposals has been appraised by various economists in ways that seem miles apart. But the apparent differences are largely semantic, stemming from varying interpretations of the percise proposals. Taken literally and as officially estimated, the President's program consists of $4.2 billion of proposed tax reductions, which would create jobs; and $4.7 billion of proposed reductions in Federal expenditures, which would destroy jobs. As Paul Samuelson and I, among others, have previously stated, this would be essentially a balanced program of job creation and job destruction that would net out approximately to zero. This result cannot be guaranteed by the fact that $4.7 billion is close to $4.2 billion. Various types of Federal expenditures and tax cuts have different amounts of bang for a buck. For example, Government payrolls and purchases have a somewhat larger and prompter impact on GNP than do tax changes. The investment tax credit is likely to provide more stimulus per dollar than would most tax reductions. The import surcharge has less restrictive effects per dollar on domestic demand than would most tax hikes. Still, when I perform all the fancy and arcane calculations that allow for these differential effects, my final conclusion reaffirms the simple first approximation that the pluses and minuses virtually balance out.

One might prefer a liberal, rather than a literal, interpretation of the proposals. As Charles Schultze pointed out to this committee, nearly half of the $4.7 billion reduction in expenditures may be viewed, not as a recommendation, but rather as a recognition of congressional delay in enacting revenue-sharing. On that view the Federal expenditures would not be significantly lower than was previously indicated, and hence points to the verdict that the fiscal program will create jobs on balance. On either interpretation, it follows that, to ensure that the fiscal program does help create jobs, Congress should reject the proposal for a net expenditure cutback.

This is an important task for the Congress but not very difficult to carry out. More difficult problems arise because the tax proposals would (1) have unbalanced effects on income distribution and on pro-

duction incentives; and (2) make a major long term sacrifice of precious Federal revenues.

IMBALANCE

The imbalance of the tax proposals is self-evident. It is reflected in table 1.

(The table follows:)

TABLE 1.—*Liability effect of scheduled and proposed changes in Federal taxes—at annual rates as of Jan. 1, 1972*

(Billions of dollars)

1. Increased personal exemption and standard deduction:	
Scheduled	−2.8
Proposed by President	−2.3
2. Social security payroll tax:	
Scheduled	+2.9
Proposed—H.R. 1	+4.5
3. Auto excise repeal proposed by President	−2.3
4. Accelerated depreciation promulgated by President	−3.0
5. Investment tax credit proposed by President	−5.5

Mr. OKUN. As the table reveals:

The combination of the accelerated depreciation rules promulgated earlier this year and the enactment of the investment tax credit would provide about $8½ billion a year of tax relief for business, a reduction in the income taxation of business of nearly 20 percent. They would make 1971 the year of the greatest business tax cut in our history.

In sharp contrast, the proposed change in the effective date of increases in the standard deduction and the personal exemption would lower individual income taxes during calendar 1972 by about $2.3 billion. In combination with previously scheduled reductions, total income tax relief for consumers would slightly exceed $5 billion, at most a 7 percent reduction in the income taxation of nonbusiness families.

Social security taxes are slated to rise on January 1, 1972—$3 billion is scheduled by present law and an additional $4½ billion is proposed by H.R. 1. If the H.R. 1 provisions are enacted, a family with a $10,000 income will have a net increase in combined income and payroll taxes.

The tax proposals are also unbalanced in their effects on various industries. They would provide $8 billion of incentives for the production of business equipment and automobiles, on top of the $3 billion from accelerated depreciation. In contrast, they virtually ignore all other industries, which produce nearly 90 percent of our national product.

The imbalances are incontrovertible. They are also, in my view, economically and socially unjustifiable.

LONG-TERM SACRIFICE

Even more seriously, we would squander nearly $10 billion a year of the long-term revenue capacity of the Federal tax system as the result of the 1971 measures of accelerated depreciation, excise tax repeal, and the investment tax credit. The first casualty of the proposed tax cuts was the President's welfare reform.

He felt obliged to drop his own baby because he could no longer afford it during fiscal 1973 after he had recommended the tax cuts.

That would not be the last casualty. The entire calendar of social progress in this country would slip seriously if these permanent tax cuts are made. We will sorely need these revenues when the economy recovers to full employment. How can anyone who sees the shame of poverty, the plight of our cities, and the state of our environment want to cut $10 billion out of the revenues that offer our main hope for correcting these ills? This is a grievous misassessment of the Nation's priorities.

I am alarmed that some who correctly sense the uneven shape of the tax proposals seek to balance the large tax relief for business by enlarging the tax cuts for households. Now their intentions are to give the consumer a better tax break—I submit that the proper word is "fracture." Permanent tax cuts would fracture the welfare of the American consumer by giving him worse public services, more inflation, and/or tighter money when the economy recovers. It is a key challenge to the democratic process that Congress right the balance and right it in the proper way by reducing the tax relief for business and providing only temporary tax reductions for individuals.

I shall not try to spell out a complete alternative to the Administration fiscal program. But I would venture two recommendations. First, the accelerated depreciation provisions should be overruled by legislative action. At best, they are an ineffective way to stimulate business investment; and at the present time, while clouded by doubts because of pending court action on their legality, they offer no reliable tax relief to business and hence very little incentive to invest. They harm the Treasury far more than they benefit business. Even the proponents of accelerated depreciation should want the air cleared: Congress should specifically either endorse or overrule this executive action. If it approves, the uncertainty about judicial revocation would be removed, and at least a little extra investment would result. And if—as I would hope—Congress rejects the measure, the tax system would be improved.

Second, a particularly attractive alternative stimulus would be a deferment—in whole or in part—of the payroll tax increase for January 1, 1972. Such a delay would not infringe on the long-run revenue capacity of the Federal system. And it would head off a rise in the cost of labor to business and a dent in the take-home pay of workers—two things this country simply does not need at the present time.

INTERNATIONAL

Let me speak very briefly about the more cheerful and promising international program, on which I am sure you will hear in detail from Mr. Bernstein. I cheer the President's decision to take the handcuffs off the dollar, enabling it to fluctuate unfettered by gold, relative to other currencies. The United States has several objectives for international economic reform. Our first aim is an adjustment of exchange rates that would put a realistic price tag on the dollar in world markets and, as I see it, we are well on our way toward that objective. Once it is clearly achieved I would hope the import surcharge is terminated. Whatever value it has had as a bargaining chip to achieve an unpegging of exchange rates, the surcharge can only have costs to us and other nations—once exchange rates are freed. Maintenance of the sur-

charge would prevent the full adjustment of exchange rates that would take place in a world market unimpeded by its uncertainties and inefficiencies. It can hold down our imports only by holding down our exports.

The international monetary system came to the brink of crisis because it lacked provision for small and continuing adjustments of exchange rates, and, in particular, for U.S. initiative to alter the exchange rate of the dollar. In accomplishing our objective to negotiate a revised international monetary system with our trading partners, these lessons should be remembered. The new system should permit a wider range of flexibility in currency prices; it should contain an automatic process to generate smaller and smoother revaluations in the future. It should in particular help phase gold out as a monetary asset, and should not be based on convertibility between gold and the dollar. The United States should never again buy an ounce of gold for monetary purposes. If we follow that course, we can relax about the price of gold. The $35 price became a symbol of denying preeminence to gold over national currencies. But if that objective is achieved in other ways, the price of gold would become just another metals price, which could move up or down with no particular significance to the U.S. economy. I should like to call the attention of the committee to a specific plan consistent with these aims that was outlined by my colleague Lawrence Krause in yesterday's Washington Post:

Let me turn last and in greatest detail to the wage-price area which again I see as cheering and promising.

Chairman PROXMIRE. I may say, without objection, at the conclusion of your oral statement that article by Lawrence Krause will be printed in the record.

WAGE-PRICE POLICIES

Mr. OKUN. In my view, the wage-price freeze marks the beginning of a new era in which the United States must develop a viable wage-price policy to make prosperity consistent with reasonable price stability. After President Nixon's action, I doubt that any President of the United States will ever again claim that wages and prices are none of the Government's business. The principle has been recognized and thereby finally removed from the sphere of partisan debate.

In some ways it reminds me of President Eisenhower's action in using deficit spending during the 1958 recession. Up to that point the Keynesian approach to fighting recession was a partisan matter and had not been accepted by any Republican President. Now we have the acceptance by a Republican President of the need for some kind of wage-price policy as an alternative to "hands off," and that issue leaves the sphere of partisan debate.

On the other hand, the experience of the 90-day freeze should demonstrate the across-the-board, rigid wage-price control is not appropriate business for the Government. This experience may even help to teach people why most economists have been so unenthusiastic about such a system. I find it a sad spectacle to view high Government officials drawing arbitrary dividing lines between old and new pro-football agreements, between 10-month and 12-month teacher contracts, and between pickles and cucumbers. I find it upsetting to witness the use

of Presidential power to abrogate lawful contracts freely arrived at by the participants. Given where we were in mid-August, all of us can and should accept the costs of the 90-day freeze. But the Nation should not and will not accept stifling controls for long.

By mid-November, the United States should have a new price-wage program that meets the following tests:

1. It should restore to the private sector the basic responsibility for decisionmaking over prices and wages.
2. It should nonetheless ensure a process of decelerating inflation.
3. It should be adaptable and maintainable with flexibility over the long run.

I believe the system should at least for the time being, be backed up by some legal sanctions, but its ultimate success will depend upon the basic acceptance and support by the American people of its effectiveness and its equity. I am now talking about the social compact issue that Gardner Ackley presented before this committee so effectively, and I agree with him. We need an intensive dialog for the next 2 months so that the major concerns and aspirations of various groups in our society can be clearly expressed and so that the program can be formulated in light of the expressions of these views.

As a possible contribution to that dialog, I should like to outline the elements of one approach designed to limit both bureaucracy and compulsion, on the one hand, and also to limit inflation, on the other. I believe this approach really goes to the heart of the basic mechanism of the price-wage spiral.

Our current inflationary problems can be reasonably traced back to the second half of 1965 when the added impetus of Vietnam expenditures and military orders turned a brisk expansion into a rip-roaring boom. Initially, the excess demand inflation erupted in prices of raw materials and in wages of unorganized workers, and particularly in the wages and prices of service industries. Not surprisingly, since these prices and wages were the most flexible ones in the economy, they responded most rapidly to excess demand. As a result of high volume and strong demand, business profits reached extraordinary levels in 1966. Meanwhile, unionized labor, tied down to longer term contracts, fell behind. When the boom was ultimately halted by fiscal and monetary restraint, organized labor was understandably determined to recapture the loss it had experienced during previous years. As a result, the negotiated settlements in the last "wage round" between 1969 and 1971 were large. The important thing, however, was that these, in turn, bolstered wage increases for unorganized workers, even though people were begging for jobs. At a time when 9- and 10-percent a year wage contracts were front page news, increases of similar size became accepted as an equitable standard for all wage earners. Thus the catch-up in the union sector was transmitted as new inflationary pressure to the nonunion sector. When business profits became squeezed as a result, firms passed their cost increases on to customers with a markup. The resulting spiral prevented the normal operation of the laws of supply and demand which should have slowed price-wage increases in the weak economy we have had during the past 2 years.

At present the spiral is no longer speeding up but neither is it significantly slowing down. Wages are rising at a rate that parallels

the cost of living plus the normal growth of productivity, and additional unit labor costs are being fully passed along through price increases. Something has to give for the wage price spiral to slow down. As long as labor is getting 8 percent, that means about a five-percent increase in unit labor costs because productivity accounts for about 3 percent of the wage increase, and as long as business passes that full 5 percent on in prices, then prices keep going up 5 percent and wages keep going up 8 percent. The wage price spiral will neither slow down nor speed up under those circumstances.

Now something has to give. In principle, success could be achieved from either direction. Once price increases stopped for a while, then I am sure labor would be satisfied with noninflationary wage increases that essentially paralleled the growth of productivity. But that approach would require business to carry the full transition burden of stabilization through lower profits. On the other hand business would no doubt agree that, once wage increases stopped exceeding productivity growth, it would no longer raise prices. Obviously that approach would make labor absorb the full initial adjustment through curtailing wage incomes. Neither approach is reasonable: the equitable solution must involve mutual deescalation, requiring labor to accept wage increases less than the sum of the past cost of living increase plus productivity and requiring business to absorb some past increases in the cost of production and thus pass into prices less than the full increase. Some central direction and some assurance of compliance on both sides is essential to get the deceleration process going.

There is no demonstrably equitable or symmetrical way of specifying the amount of absorption of past cost of living increases that labor should accept and the amount of absorption of past cost of production increases that business should accept. But let us mention a pair of standards that might serve as a reasonable basis for discussion. First, on pay, the hourly compensation of employees (including fringe benefits and including executives as well as production workers), should rise no more than the sum of normal economywide productivity growth (3 percent) plus half of the past year's cost of living which at the moment would be half of 4½ or a little bit more than 2 percent. That would add up to slightly more than 5 percent as a wage standard.

Special qualifications might be made for productivity incentives, for profit-sharing arrangements that extend to all employees, or for grave inequities. Obviously, promotions and normal seniority advancements can be fully consistent with an overall pay structure that does not rise by more than the specified standard.

Second, on prices I would say increased costs of labor and material, where the costs are reckoned after allowance for some normal improvement in productivity, should be absorbed by business firms unless and until unit production costs are increased by 1 percent. In other words, business should absorb a 1-percent increase in costs. Beyond that they should pass on their increases in costs with no markup as price increases.

Qualifications on cost absorption may be required for firms operating unprofitably or at abnormally low margins on sales. Past cost increases should be calculated over the period from the last price adjustment on any product or, at most, from a year earlier.

I would like to exempt raw materials and other products traded in commodity markets. Indeed, to guarantee against black market, I would exempt any product (or any type of labor skill) for which the standards would create a genuine shortage but it is important to recognize that, so far as I know, lumber is the only commodity which seems to be anywhere near the zone of excess demand. Every other commodity is suffering from cost-push rather than excess demand inflation. As I would envision this set of standards, industrial price increases exceeding 1 to 2 percent would be highly unusual.

A brief general statement and interpretation of the standards could be issued in mid-November calling them to the urgent attention of every American. At that time all prices and wages should be simultaneously unfrozen. However, the Government would retain the power to roll back any price or wage increase that flagrantly violated the standards and to freeze that price or wage subsequently for a substantial period.

Chairman PROXMIRE. I just want to get a clarification here, Mr. Okun, because this is so vital and important, very interesting. It is the most specific and definite recommendation we have had. You recommend a 5-percent increase, roughly 5 percent, plus a little bit in wages, which you think would result in confining price increases to 1 to 2 percent?

Mr. OKUN. Yes; I believe that——

Chairman PROXMIRE. And you believe that would be a reasonable pattern to aim for after the 90 day freeze?

Mr. OKUN. That is essentially it.

Chairman PROXMIRE. Thank you.

Mr. OKUN. I am now talking about a mechanism for administering this pair of standards. We would want no controls directly on any price or wage after mid-November but would rely on this contingent power of the Government to roll back any price or wage increase that flagrantly violated the standards and then to freeze that price or wage subsequently for a substantial period.

The sanction would have to be applied very selectively only to those prices and those wage settlements that would be particularly important to the overall price level or that would establish significantly adverse precedents and patterns. The more general success of the program would depend on the cooperation of the American public and the change in the behavior of the visible prices and wages that have had so much to do with the inflationary atmosphere of recent years.

Under such a system, direct controls on profits should be no more necessary and no more appropriate than would controls on payrolls. More jobs and better jobs should expand real payrolls, and more production should raise real profits. Increases in labor and business earnings from noninflationary prosperity would be a mark of success rather than a sign of failure. Of course, the Government would use profit and cost data as tests of compliance with the price standard, but with the clear aim of holding down prices. Indeed it is fair to say that most of the Government's staff effort should be focused on such monitoring of the price standard because employers would help to enforce the wage standard. But neither direct controls nor penalty taxes on profits could help enforce the price standard.

I can't improve on the scientific verdict that Gardner Ackley presented yesterday that the excess-profits tax is a lousy tax. The excess-profits tax or any kind of penalty tax, or any kind of administrative hold down on profits that does not work through holding down prices would encourage wasteful advertising, expense account living, and over-full employment of shrewd accountants. Why such measures should have the slightest appeal to American workers is simply beyond my comprehension.

Nor would interest rates require special control measures. If the economic program is successful, interest rates will fall further and stabilize as prosperity is regained. Any upsurge of interest rates would be a symptom of important problems that should be recognized and diagnosed promptly rather than suppressed by a freeze. It would mean either that the Nation's economy had begun to soar too rapidly or else that Federal Reserve monetary policies had become inordinately tight. Under this system, the Federal Reserve would surely recognize that moderate interest rates were a social target, and would be obliged to focus on the price of money as well as its quantity.

In a variety of other ways, the Government could demonstrate its whole-hearted dedication to the objective of noninflationary prosperity and could provide a powerful set of supports for the success of the price and wage standards. Several of the examples below are the ideas of Charles Schultze, and he has additional ideas on other Government actions to support a set of price and wage standards.

First, Congress should ensure that pay increases for Federal employees are fully consistent with the wage standard.

Second, we need the cooperation of our Mayors and Governors on their price and wage decisions. They could also help the national effort by invoking a moratorium on increases in those taxes which feed directly into the cost of living, such as excise and general sales taxes. Congress might want to make sure that Federal funds to States or cities are not used to defray price or wage increases that exceed the national standards and put such provisions in grant legislation.

Third, the heads of Federal and State regulatory agencies should be asked to apply the standards to regulated public utilities to the full extent permitted by Federal and State laws.

Fourth, if major increases in the prices of exempted farm commodities threaten to raise food prices, the President should use the discretionary powers available to him under the farm program, such as the setting of rates for commodity loans, the sale of surplus stocks, and the establishment of acreage levels and of beef import quotas.

Fifth, in the area of medical costs, the Department of Health, Education, and Welfare should develop rules for reimbursing physicians and hospitals which would be consistent with the price and wage standards. The cooperation of Blue Cross and other major private insurance programs should be sought.

Now, this has taken me into considerable detail on the phase 2 program, and I hope the committee will excuse me. This isn't the Okun plan. I have no great personal attachment to the specifics here or even the overall design. Indeed there is nothing very novel about this. The key economic feature of these standards calling for mutual deescalation on prices and wages can be traced back to George Perry's state-

ment before this committee in January 1968. The key enforcement feature of trying to pick rotten apples out of the barrel rather than to define ideal apples has many precedents in American law and practice.

I went into this in detail because I think the phase 2 issue is so critical and I think it needs a prompt and intensive public airing.

Gardner Ackley set forth a lot of the basic fundamental issues and questions about it. I hope that my sketch of one particular approach may provoke questions and reactions and may illustrate some of the problems and opportunities of any price and wage policy.

Basically no American wants a license to depreciate the purchasing power of the dollar. Our stagnation and inflation has had no villains. It has had only 200 million victims. No single group could stop inflation; all groups have been on a treadmill where they have had to run fast merely to keep up. With leadership and a proper spirit of cooperation, this Nation can get off the treadmill and can begin to achieve prosperity and price stability simultaneously.

Thank you.

(The newspaper article referred to in Mr. Okun's oral statement and submitted for the record by Chairman Proxmire follows:)

[From the Washington Post, Aug. 31, 1971]

TWO ECONOMIC GOALS IN SIGHT

(By Lawrence B. Krause)

Now that all the major currencies of interest to the United States are floating against the dollar, we are on the threshold of achieving the first of two international objectives of President Nixon's new economic policy. The two objectives are the correction of the overvaluation of the dollar to re-establish the competitiveness of American products in world markets and the reform of the international monetary system to serve better the present needs of the entire world. The overvaluation of our currency will be solved by the adoption of a new set of exchange-rate parities which will effectively devalue the dollar. As compared with their old parities, the Japanese yen might be revalued between 10 and 15 per cent, the German D-mark between 8 and 10 per cent, and the Canadian dollar might trade around par with the U.S. dollar. This will restore equity between American producers and their competitors at home and abroad. Foreign competition will not be crippled, nor should it be. We are dependent on competition to serve the needs of the American people. Some inefficient American producers will not be satisfied, but the economic welfare of the entire country cannot be sacrificed to their special needs.

President Nixon's temporary 10 per cent import surcharge was the instrument that helped most to bring this about. While it was useful as a bargaining tool, however, the surcharge is a significant barrier to international trade. Moreover, while the surcharge is in effect, imported capital goods do not enjoy the benefit of the proposed tax credit for investment; this discrimination constitutes an additional new barrier to importation of foreign goods. When the new parities are adopted, the surcharge must be promptly removed. It is inconceivable that foreign governments could stand still while their exports were subject to all three sources of competitive loss: those caused by appreciation of foreign currencies, the 10 per cent import surcharge, and the discrimination in the investment credit. If the United States attempts to retain the surcharge after parity realignments, we will have snatched defeat from the jaws of victory, for it will bring on foreign retaliation against our exports which we have so far successfully avoided.

Our second objective—the reform of the international monetary system—will be slower in coming and will involve extensive negotiations with all interested countries. The purpose of the reform is to amend those elements of the current system which have caused periodic international financial crises. The principal aim is to encourage flexibility in exchange rates so that needed adjustments are accomplished more quickly and thus in smaller doses. The present system has rigidified exchange rates to such an extent that massive disequilibria have devel-

oped, requiring large exchange-rate changes which have enticed and enriched currency speculators. The reform should also provide a mechanism for the needed increase in international money in an orderly manner so that world prosperity will be encouraged.

There is already general agreement on some of the elements of the reform. The International Monetary Fund (IMF) should permit exchange rates to fluctuate within wider margins around established parities. For example, they could be allowed to fluctuate within 3 per cent on either side of a fixed rate, instead of the present 1 per cent. This would allow Germany, for instance, to have tighter money if it wanted it without attracting funds from countries like the United States which had easier money. Wider margins will also provide some market evidence as to whether a particular currency is becoming over or undervalued and should change its parity.

Following from this, support is growing to amend the IMF so that "fundamental disequilibrium need not be proven before an exchange parity can be changed. If small changes—the least disruptive kind—are to be encouraged, then evidence less difficult to establish must be acceptable to verify the required case for a devaluation or revaluation. Indeed the existence of market pressures which continually force a currency to stay near its floor or its ceiling should be sufficient evidence in most instances.

There is no consensus, however, on what role the U.S. dollar should play in a reformed system. Under the old rules of the IMF, other countries stated their exchange-rate parities in terms of the dollar, and the dollar itself was specified in terms of gold. Both gold and dollars served as international money or reserves, but only dollars were actually usable by countries to intervene in exchange markets. This system permitted the United States to finance its balance-of-payments deficits by issuing new dollars, but prevented the United States from correcting its balance-of-payments problem through a devaluation of the dollar itself, since the dollar's value was determined by the collective action of other countries. The introduction of Special Drawing Rights (SDRs) as a new form of international money altered the system by making it less dependent on gold, but did little to change the role of the dollar.

It was the strain on the U.S. economy coming from the excessive dependence of the international monetary system on the dollar that forced President Nixon to suspend the convertibility of the dollar into gold or SDRs. But what comes now? In fact, a more rational system is possible which more equally spreads the burdens involved. The outline of such a system is sketched below:

First, all countries would specify the value of their currencies in terms of SDRs including the United States. Originally one dollar would be made equal to one SDR. The parity of the dollar could thus be changed almost like that of other currencies. Other countries would still intervene in their exchange markets through dollars, but they would need relatively small working balances of dollars for this purpose. The difference between the dollar and other currencies is that there would be only an indirect market test of the dollar's value. If most currencies were clustering near the top of the permitted exchange-rate margin, then the dollar itself should be devalued, and likewise the dollar should be appreciated if other currencies were near their floors. Thus, all countries would have available to them the most efficient instrument for correcting a balance-of-payments problem, namely changes in exchange-rate parities.

Second, other countries should be invited to exchange the excess dollars they hold in their official reserves for a special issue of SDRs by the IMF. The dollars would then become a permanent income-earning asset for the IMF, which would use its dollar earnings to pay interest on SDRs. Countries, if they so desire, could continue to hold dollars but they would recognize that the United States was not providing any exchange-rate guarantee on them. Needed increases in reserves would come from new issues of SDRs, since the United States would correct any deficit on its accounts through a devaluation of the dollar.

Third, all official gold holdings would be sold to the IMF also in exchange for a special issue of SDRs, and gold would be completely demonetized. Gold has long ceased to be a usable reserve asset and need not be retained. The IMF would sell the gold gradually to the World Bank at the old official price of $35 per ounce. The World Bank would slowly sell the gold in the private market, earning whatever premium then existed, and utilizing the profits for soft loans or grants to less developed countries. Thus the windfall profits of demonetizing gold would go to economic development in the world's poorest nations.

Some countries may not want to part with their gold reserves. It would be unwise to try to compel them to do so, but other countries would not be obliged to buy or sell gold to the non-cooperating country. Of course the country could sell official gold into the private market and earn the premium for itself. But such an action would quickly be recognized for what it was, a selfish action on the part of that country.

This is merely an outline for a reform. Many details must be added. However, it has all the essential elements of a viable system. The United States would no longer be forced to carry an intolerable burden. All countries would be treated equally. Finally, the less developed countries would be given a positive interest in the reform which is only just, given the short shrift they have gotten from the entire monetary upheaval.

Chairman PROXMIRE. Thank you very much, Mr. Okun, most helpful.

Mr. Bernstein, we are especially delighted to have you as an outstanding international economist and expert. We have neglected that aspect of this situation and we shouldn't because, as I understand it, this was the principal reason why the President acted precipitously as he did. Once he acted here it was necessary to act on the domestic economy. So we are very anxious to get your advice on the President's recommendations and what we should do about it in Congress.

STATEMENT OF EDWARD M. BERNSTEIN, PRESIDENT, EMB, LTD.

Mr. BERNSTEIN. Senator, I have not had time to prepare a statement but I would like to submit one for the record. If Monday is not too late for the record you will have it then.

Chairman PROXMIRE. Monday will be fine.

Mr. BERNSTEIN. What?

Chairman PROXMIRE. Monday is fine. We would be delighted to have it.

Mr. BERNSTEIN. Thank you.

The depreciation of the dollar in relation to the currencies of other large industrial countries was essential for the recovery of the U.S. economy, for establishing a strong balance of payments and for restoring confidence in the international monetary system.

If the depreciation is achieved in an orderly way in cooperation with other countries and in consultation with the International Monetary Fund it will be of great benefit to the United States and to the world economy.

I have at various times estimated the impact of the balance of payments on production and employment in the United States. In general, I take the view that for our balance of payments to be strong, our surplus of goods, services, and remittances would have to be adequate to finance U.S. Government aid and normal private capital outflow, but allowing for an inflow of foreign capital, That would mean a surplus on the order of $8 to $9 billion on goods, services, and remittances.

In the first half of this year we had no surplus at all on goods, services, and remittances. As you know we actually had a deficit in our trade balances.

An $8 to $9 billion a year surplus on goods, services, and remittances in the first half of this year would have been eight-tenths of 1 percent of the GNP. The direct effect, therefore, would have been to increase the GNP by roughly $8 to $9 billion compared to what it actually was.

Nearly all of this improvement would have had to be in trade. If the direct effect on employment were proportional to the increase in the GNP, it would have reduced the unemployment rate from an average of 5.9 or 6 percent in the second quarter to around 5.2 or 5.3 percent.

Moreover, nearly all of the improvement in the trade balance would have been in the manufacturing industries. Our domestic demand would have been satisfied more from domestic production instead of from imports, and our domestic output would have included a larger volume of manufactured exports. With a $250 or $260 billion a year gross product of manufacturing, this would have involved a 3 percent increase in the Federal Reserve index of production of manufactured goods. This is no small impact that the international sector has on our economy.

Apart from this, a strong balance of payments, especially under conditions of monetary stability, has a direct effect on interest rates. In a paper I published on the international relationship of interest rates in 1968 I concluded with this observation: Differences in interest rates not only reflect differences in the demand and supply of long term funds in the different monetary markets of the world but also expectations on the currency, that is to say on inflation, and on exchange rates. If we get the dollar strong so that people have confidence in the dollar, interest rates will be down.

I don't think anybody needed convincing that restoring the U.S. balance of payments was desirable and doing it by depreciating the dollar was inevitable. I do want to point out, though, that as we eliminate our deficit it has important economic effects on other countries. Just as the elimination of our deficit will add to production and employment in this country, so the diminution of the surplus in other countries will reduce production and employment in these countries, unless something is done. I think it is important for us to make sure in collaboration with them that the restoration of a well balanced pattern of international payments does not lead to deflation in the world economy. What this really means is that all of the adjustments that are needed internationally, just as all the adjustments that are needed domestically, are best made in an environment of high levels of output and employment and with a minimum of restriction on world trade.

The United States doesn't have to keep out of this country the goods and services that other countries can produce with a comparative advantage. All we have to do is to make sure that we don't give away the whole range of imports from pantyhose to steel, from transistor radios to automobiles, to the rest of the world, merely because we have an overvalued currency. We want to compete but we want to compete with exchange rates that are properly adjusted between the U.S. dollar and the currencies of other industrial countries.

Now, getting down to concrete facts, the index of export prices in the United States and Japan and Europe, the balance-of-payments data, and the apparent intentions, as we can read them, of the Government of the United States would seem to indicate that the intended average depreciation in the dollar is between 12 and 15 percent. This is a little bit more than the differential in the prices of exports of manufactured good in the in the United States, Europe, and Japan.

Roughly at the beginning of this year the index of export prices of manufactured goods had risen since the base, 1963, by about 12 or 13 percent more in the United States than in Japan. In dollar terms, our prices rose by around 9 or 10 percent more for manufactured export goods since 1963 than the prices of all of the European industrial countries averaged together—that is, after allowing for appreciation of the D-mark, and depreciation of the franc, and the pound sterling.

Now, of course, our——

Chairman PROXMIRE. What was that base date again?

Mr. BERNSTEIN. 1963. It would be about the same measured from 1964. But 1963 is the base date that international institutions use.

That isn't the whole cause of our difficulty in trade. The plain fact is that the growth in the productive capacity of Europe and especially of Japan has made it possible for them to offer larger supplies of exports of manufactured goods, even without the further price advantage that they got during our inflation. We have to offset that.

So, we have had a deterioration in our competitive position for two reasons: The greater rate of inflation of U.S. prices of manufactured export goods, and the greater capacity of Europe and Japan to supply manufactured export goods, even those we used to regard as particularly American in character.

If we analyze the composition of our trade, we find that more than half of our imports and nearly half of our exports consist of foods, feeds, and beverages and industrial supplies and materials. Imports and exports of these products would be affected very little by a depreciation of the dollar. It is the half of our exports and imports consisting of manufactured goods that are expected to be responsive to the change in relative prices resulting from a depreciation of the dollar. These exports and imports together are now running at an annual rate of $45 billion.

Assuming an increase of about $8.5 billion a year from the trade balance in the first half of 1971, and assuming the average price elasticity for both exports and imports of manufactured goods is about 1.7, it would take a depreciation of about 13 percent to get this necessary improvement in the trade balance. But if the elasticity is a little less, and if you make allowance for the fact that foreign exporters will try to restore a bit of their competitive position by cutting profit margins, I think maybe 15 percent is nearer right.

Then you have to read what the administration must have had in mind with the 10 percent surcharge. The 10 percent import surcharge, without making any allowance for the depreciation that has already taken place in the dollar, raises by 10 percent the landed cost of nearly all dutiable imports. Now I find it hard to believe that the administration, having given the American producer this correction in his relative price position, is going to take it away or isn't at least going to offset it by the depreciation. As the average depreciation of the dollar is more like 6 percent now, and the import surcharge, where it applies is 10 percent, we are getting nearer to the upper limit of a 15 percent depreciation that would be needed. Otherwise, I have a feeling that many American industries are going to say, "We are worse off after this depreciation than we were with the import surcharge."

Having said that, let me get around to explaining how we get an average depreciation of 12 to 15 percent.

Senator, I hope I am on the topic you wanted——

Chairman PROXMIRE. What is that, sir?

Mr. BERNSTEIN. This is the topic you wanted me to discuss?

Chairman PROXMIRE. Yes, indeed. It sure is.

Mr. BERNSTEIN. The raw materials countries are not going to feel very happy about their currencies departing from their dollar exchange rate. The explanation is very logical, and that is they don't want to see a drop in the local currency prices of their basic export commodities. That is what would happen, you see, if they allowed the depreciation of the dollar to operate against them. So I expect that all of the dollar countries in Latin America will go with the dollar, they are in fact going with the dollar, that many of the sterling countries won't want a depreciation much beyond what has already happened in the dollar relative to sterling.

I don't think we ought to worry about that. These aren't the goods that are involved in restoring our balance of payments. What we want to do is to get an adequate average depreciation against the currencies of the large industrial countries.

Getting a 12–15 percent average depreciation against them is not something we can do by ourselves. We have to have the cooperation of other countries for a variety of reasons. It can't be the same depreciation for all the countries. They are not in equally strong surplus position, they are not equally well supplied with reserves, they are not equally affected by American competition, as it would be after the depreciation of the dollar. So it has to be a differential depreciation.

I have not put down the amount of depreciation for each country because that would hamper negotiations, but I have put down the order of magnitude of the depreciation we would expect against different countries. That is to say, the ones I name first would have the largest and the ones I name last the smallest appreciation of their currencies against the dollar. All of them would have an appreciation, every one I mention, against the dollar, in this order: Japan, Germany, and Switzerland, then the Netherlands, Austria, and Belgium, and finally I put on one long broad base, Italy, France, the United Kingdom, and the Scandinavian countries. They would have the least appreciation against the dollar.

Now, I come to the question whether this is possible. Until the Japanese were ready to let the yen float, it would not have been possible to get an adequate depreciation of the dollar, one that would restore our competitive position. I put great emphasis on this in a speech in Munich to an international bankers' conference. By and large, the European countries know that the balance of payments of the United States must be restored, and they are going to have to give up some of their competitiveness. As I said in Munich, because it seemed to be the right place to say it, Germany didn't mind appreciating the D-mark against the dollar even though it meant that Volkswagen and Telefunken would have more trouble in competing with General Motors and Ford and with Zenith. They had a great objection to appreciating so much as to surrender part of their market not only to American companies but to Toyota and to Sony.

When a country appreciates it is losing competitiveness across the board, not only against the United States but against every other

country that did not appreciate to the same degree. As Japan is the second largest economy in the non-Communist world, as it is the third largest exporter of manufactured goods in the world, Japan is the key to getting a proper pattern of foreign exchange rates. Now that the Japanese have agreed to let the yen float it seems to me that it will be easier for the United States to sit down with the Group of Ten and to consult with the International Monetary Fund on what is a proper pattern of exchange rates.

I have left out Canada, although it is one of the great industrial countries, because the relations between Canada and the United States are so close and so complex that the best approach to the Canadian exchange rate is to say that after the U.S. dollar rate is adjusted relative to the currencies of other industrial countries, the Canadian exchange rate will then be adjusted to the proper U.S. dollar rate.

So far no currency has depreciated enough relative to the dollar. Of course the fact that Japan held off so long made the Europeans slower and more cautious. Since the yen has floated the dollar has depreciated a little more against the European currencies. I think probably the principal explanation, although it is not altogether satisfactory, is this: The biggest demand for foreign exchange is to pay for imports. We have been importing at a rate of about $45 billion a year in the first half of this year. I suppose that the total U.S. payments are on the order of $75 to $80 billion in one direction.

In the demand for foreign exchange for current payments, U.S. imports are two-thirds of this demand. In the overall U.S. demand for foreign exchange, including transfers of investment funds, U.S. imports are more than half the total demand.

Now, when the importers have to pay a 10-percent surcharge, the amount they can pay for the exchange and still afford to import the goods, I mean, to make a profit in selling here is limited. I think as long as the 10-percent import surcharge is in effect you can't expect a depreciation of the dollar on the average to run 12 to 15 percent.

This does raise another question: Why don't the buyers of exchange, including the speculators, who don't pay an import surcharge, realize that we haven't yet reached the appropriate depreciation of the dollar and start buying other currencies? Well, my guess is they are doing it but they can't do it on a scale to offset the temporary cut in the demand of importers.

There is other evidence, however, in the exchange market that everybody expects the dollar to depreciate more. This morning's New York Times has a table of exchange rates in the New York market, and I ran the forward exchange rates through the machine. They show this: Yesterday in New York the premium on forward D-marks for 3 months delivery was at an annual rate of over 4 percent. That means the dollar was at a discount, future dollars were worth less than present dollars by 4 percent per year in buying D-marks. The premium on Swiss francs or the discount on the dollar 3 months forward was over 7 percent a year.

This isn't all due to expectation of further depreciation of the dollar. There are interest rate factors in there but I would have said that the interest rate factor would not have been more than 1 or 2 percent a year, and the rest of the discount on the forward dollar is the mar-

ket's expectation that 3 months from now the dollar will have depreciated a little more relative to these European currencies.

The objective of our exchange rate policy should be to get an adequate depreciation. If we can get a 12- to 15-percent depreciation of the dollar to restore our competitive position, I wouldn't care one whit whether we did it through a devaluation of the dollar or an average 12 to 15 percent revaluation upward of the other currencies. I don't have any ideological hangups on these things. I have been through too much trouble with exchange rates in too many countries to be bothered with the ideology. The important thing is the depreciation of the dollar.

If it would make Americans happier to have it through a revaluation upward of the other currencies, and they were willing to do it, they wouldn't find any objection from me. On the other hand, I do feel that there are some aspects of the question of depreciation, devaluation and revaluation which are important to us and other countries.

Chairman PROXMIRE. At this point, Mr. Bernstein, I think it would be helpful because of the limited time and the fact that both Congressman Conable and I would like to question Mr. Okun and you, if you would simply give us a summary of how you envision this in terms of what should happen to the international exchange system.

Mr. BERNSTEIN. That is what I am planning to do.

Chairman PROXMIRE. And the role of gold, if any.

Mr. BERNSTEIN. I am going to do all of those things.

Chairman PROXMIRE. We would like to have it in maybe 4 or 5 minutes if you can do that.

Mr. BERNSTEIN. Then I had better hurry on with it and I will just enlarge it in the record.

Chairman PROXMIRE. All right.

Mr. BERNSTEIN. I come to the conclusion that it would be better for the United States to achieve the depreciation we want partly through devaluation of the dollar. I conclude that because I think other countries have the same political trouble with their parliaments on reevaluation that any administration would have with Congress in proposing a devaluation. It is one thing for Germany and Japan to say, "Look, we are only revaluing by 8 or 9 percent. The rest of the depreciation is not our fault, the Americans did it." For them to come to their big industrialists and say, "We are revaluing by 15 or 16 percent" would cause them as much political trouble, at least, as we would have with devaluation.

Second, I see no reason why a country as sophisticated and grown up as the United States should be troubled by the problem of devaluation. This is not 1931 or the 19th century. We all now understand that exchange rates are part of a whole complex of policies that affect production and employment as well as world trade.

The $35 price of gold is not directly enshrined in any legislation. The Gold Reserve Act of 1934 gave the President the power to fix the price of gold between $35.45 an ounce and $41.34 an ounce. It was in an Executive order dated February 1, 1934, that the $35 price was set. The Bretton Woods Agreement Act does say that no change in the parity of the dollar shall be proposed to the International Monetary Fund except after prior authorization of Congress.

A devaluation would need the authorization of Congress. I see no reason Congress should hesitate about this responsibility. The Constitution of the United States says that Congress has the power to coin money and regulate the value thereof and of foreign coin. If an administration can change the value of the dollar, and that is what depreciation is, whether it is done with devaluation or not, without any authorization of Congress, merely by forcing a revaluation of their currencies on other countries, then Congress does not in fact have the power to regulate the value of our money. It is the constitutional duty of Congress to say whether the depreciation of the dollar should be accomplished within the framework of our laws, including the intent of the Bretton Woods Agreement Act.

Some people have an ideological hangup on gold. I have always been against the gold standard. In fact, I was the first writer on money to make the point that what constituted a gold standard was not defining the currency in terms of gold but restricting the money supply on the basis of the amount of gold reserves. Anyway, a Princeton Ph. D. thesis on the Meaning of the Standard says that I was the first to make this point. I am glad we went off the gold standard in 1933 and never returned to it. When we found that the gold reserve was not adequate for the money supply in 1945, we asked Congress to change the gold reserve requirements. It was my job to explain the economics to Congress. I should like to put into the record two paragraphs from the preface to my book, "Money and the Economic System," published in 1935.

Particularly, the blind worship of the old gold standard has prevented the development of a monetary system suited to our needs. It has been assumed that gold is a natural and inevitable standard; and that any proposal to replace it must be fallacious and heretical. For many years the gold standard was an end in itself; and the economic system, for better or worse, had to adapt itself to the limitations placed upon it by an antiquated monetary standard.

It is necessary to reconsider the place of money in our economic system. It must be realized that in a society of free enterprise in which production is undertaken for profit, the economic life of the community is to a large extent influenced by money and prices. The fundamental problem of monetary policy is whether this influence is to be exerted through the haphazard movement of prices in an uncontrolled monetary system, or through the directed movement of prices in a managed monetary system. The community depends on money and prices to organize production, to distribute the national income, and to direct the utilization of its income in consumption and production. It is evident that a monetary system based on gold cannot perform these functions satisfactorily.

Lord Keynes said that the Bretton Woods system was the opposite of the gold standard. The Articles of Agreement of the International Monetary Fund provide for declaring parities in gold as a common denominator. If we have a hangup on declaring a new parity in gold, I can think of many ways of doing it differently, and from what Mr. Okun tells me, Mr. Krause said the same thing in yesterday's Post. We can say to the Fund: "Did you see the exchange rate for the dollar in D-marks on December 23? That is our parity. That is not the way we are supposed to declare it to the International Monetary Fund under the rules. We can amend the rules to say that parities can also be declared in SDR's." I myself feel this is all flimflam and it doesn't make a bit of difference.

I have two reasons for wanting the United States to take part of the depreciation through a devaluation, roughly 7 to 8 percent, that is al-

most half. The first is that I think Congress ought, in fact, to pass on the question whether we want to have a depreciation of the dollar accomplished by a devaluation of the dollar plus a revaluation of other currencies. I do not think we will get an adequate depreciation without some devaluation of the dollar.

Second, it makes a big difference in the reserves of the world. If the depreciation of the dollar is achieved exclusively by marking up the other currencies it means that the price of gold in D-marks and yen is reduced. It means that the value of SDR's in D-marks and in yen will be reduced. However accomplished a depreciation of the dollar will reduce the currency value of aggregate monetary reserves. It will be reduced a good deal more if we don't devalue. But if we devalue by 7 or 8 percent, around $70 billion of reserves in the world, including gold, SDR's, reserve positions in the International Monetary Fund, and foreign exchange other than the dollar, would be marked up by roughly 7 or 8 percent. That would be $5 billion. The quotas of the International Monetary Fund would be marked up in dollars by nearly $2.5 billion. Our reserves would go up by $1 billion and our quota by more than $500 million. To my mind, this is a much more important consideration than the vain glory of being able to say that we have not changed the dollar price of gold.

I might add that a 7- to 8-percent devaluation of the dollar would be bearish for gold. The unique role of gold is not going to continue after this crisis. We can't get rid of gold as a reserve, there is too much of it in the world. We ourselves with all of our troubles have 25 percent of $40 billion of the monetary gold in the world. What we should do is to put gold in a position where it serves as reserve but never has an effect on the reserve behavior of countries. We don't want currencies convertible into gold. We want currencies to be convertible under the International Monetary Fund in all reserve assets without discrimination among gold, dollars, and SDR's. If you will permit, I should like to put into the record my most recent paper entitled "A Reserve Settlement Account for the International Monetary System."

Chairman PROXMIRE. I will be happy to accept that for the record.

(The document referred to follows:)

A RESERVE SETTLEMENT ACCOUNT FOR THE INTERNATIONAL MONETARY SYSTEM

(By Edward M. Bernstein)

U.S. PAYMENTS PROBLEM AND THE WORLD ECONOMY

The U.S. balance of payments is of enormous importance to the world economy. It is not merely that the United States is by far the largest trading country and that a major part of international capital movements are to and from the United States. With the Bretton Woods system of fixed parities, the economic situation in the United States inevitably affects output, prices, and interest rates in other countries. Moreover, the dollar is the principal currency used in international transactions and holdings of dollars constitute a considerable part of the monetary reserves of many countries. For these reasons, the well-being of the world economy depends on the maintenance of a strong and stable economy and a strong and balanced international payments position in the United States.

Obviously, the ecoomic situation in the United States has not been very satisfactory in recent years. Far from having a strong and stable economy, the United

States had a war and investment boom from 1965 to 1969 and has had a mild recession since then. Prices have risen continuously for seven years, and although the excess demand has been eliminated, the cost of inflation persists. The underlying payments position of the United States, as shown by the balance on goods and service, deteriorated from 1964 to 1969, and the improvement in 1970 was moderate. The weakness in the U.S. balance of payments was masked by the large inflow of Eurodollars in 1968 and 1969; it emerged in dramatic form with the enormous deficit on an official reserve basis in 1970. The United States is confronted with difficult economic problems and this inevitably creates doubt and uncertainty about the dollar.

Although progress has been slow, the United States will almost certainly end the inflation and resume a high level of production and employment. On the other hand, there is great concern about the capacity of the United States to deal with the balance of payments problem. In this country, there is an attitude of resignation, if not of indifference, to the payments problem among some economists. In Europe, there is a widespread feeling that it is futile to wait for a restoration of the U.S. balance of payments. In some respects, these views are reminiscent of the late 1940s and early 1950s. At that time, some reputable economists held the view that a permanent dollar scarcity was inevitable. Today, some equally reputable economists hold the view that the dollar glut will be permanent. There is no sound economic basis for such extreme views. The U.S. balance of payments, like that of any other country, can be restored by appropriate corrective measures.

The problem is difficult, although not as great as it would seem from the exaggerated deficit of 1970. A deficit of $10.7 billion on an official reserve basis is not surprising in a year in which short-term liabilities to foreigners (other than monetary authorities) were reduced by $6.2 billion, mainly through repayment of Eurodollar borrowing by U.S. banks. The deficit this year will again be very large, as repayments by U.S. banks in the first quarter are about $3 billion. There is no way of dealing with that part of the deficit attributable to the return of short-term funds except to allow it to run its course. By the end of the year, the liabilities of U.S. banks to their foreign branches will probably be down to the level that prevailed before the credit squeeze of 1966. For the future, such massive and disruptive movements of short-term funds will have to be avoided. That will require greater international coordination of monetary policy and cooperation by the leading financial centers in supervising the Eurodollar market.

The solution to the U.S. payments problem does not require the maintenance of a low level of production and employment. That would be contrary to the Bretton Woods principle that adjustment of the balance of payments should be through measures not destructive of national or international prosperity. On the other hand, it is essential to halt the inflation and to reduce the overseas military expenditures of the United States. Under favorable conditions, the United States should be able to restore a satisfactory balance of payments within a few years. If that cannot be done with the present pattern of exchange rates, it will be necessary either to devalue the dollar or to appreciate the currencies of the surplus countries. In one way or another, the U.S. balance of payments will be restored. Other countries will not continue indefinitely to exchange goods and services and capital assets for dollar reserves they do not need.

U.S. BALANCE OF PAYMENTS AND RESERVES

Because the dollar is a reserve currency, the state of the U.S. balance of payments on an official reserve basis affects the total amount of reserves. The precise effect will depend on how the U.S. deficit or surplus is settled. If the balance is settled by transfers of gold or Special Drawing Rights, aggregate reserves are unaffected. If the deficit or surplus is settled by the drawing down or accumulation of convertible currencies by the United States, aggregate reserves will decrease or increase. If the deficit or surplus is settled by drawings on the International Monetary Fund, there may or may not be a corresponding change in aggregate reserves (the gold tranche position of all countries). If the U.S. deficit is settled by the accumulation of dollar reserves by surplus countries or the U.S. surplus is settled by the drawing down of reserves by deficit countries, aggregate reserves are increased or decreased correspondingly.

SETTLEMENT OF U.S. BALANCE OF PAYMENTS ON AN OFFICIAL RESERVE BASIS, 1963-70

[Million dollars]

	1963	1964	1965	1966	1967	1968	1969	1970
Surplus or deficit (−)	−2,011	−1,564	−1,289	266	−3,418	1,641	2,700	−10,686
Assets (increase +):								
Gold	−461	−125	−1,665	−571	−1,170	−1,173	967	−787
SDRs								−16
Convertible currencies	113	220	349	540	1,024	1,183	814	−2,152
IMF gold tranche	−29	−266	94	−537	94	870	1,034	−389
Liabilities (increase −):								
Liquid liabilities	−1,673	−1,075	18	1,595	−2,020	3,101	517	−7,615
Nonliquid liabilities	39	−318	−85	−761	−1,346	−2,340	996	273

The manner in which the deficit or surplus in the U.S. balance of payments is settled varies sharply from year to year. The composition of the settlement items depends upon whether the corresponding surplus or deficit accrues to countries that prefer to hold gold and SDRs or to countries that prefer to hold dollars. It also depends on whether the United States engages in swap operations with the surplus or deficit countries and on the extent to which the United States or other countries draw on the IMF. From 1963 to 1970, the cumulative deficit of the United States on an official reserve basis was $14.36 billion. Net gold settlements amounted to $4.99 billion—about 35 per cent of the cumulative deficit. In the same eight-year period, the holding of dollar reserves increased by $10.69 billion—about 74 per cent of the cumulative deficit. Interestingly enough, in this period U.S. holdings of convertible currencies increased by $463 million and the U.S. gold tranche position by $871 million. Such transactions are in the nature of reserve credit, sometimes extended by the United States to other countries even when the U.S. balance of payments is in deficit.

The U.S. balance of payments was a major factor in the growth of aggregate reserves from 1963 to 1969 and the predominant factor in 1970. Between the end of 1962 and the end of 1969, the total reserves of members of the IMF increased from $63.1 billion to $77.7 billion. There was a slight decline in their gold reserves, although this was offset by an equivalent increase in the gold holdings of the IMF. There was an increase of $2.9 billion in the reserve position of members of the IMF, much of it due to drawings of the United Kingdom. U.S. liabilities to monetary authorities of other countries increased by $3.1 billion and U.K. liabilities increased by $2.7 billion, mainly the counterpart of reserve credits extended by other countries. Reported foreign exchange holdings increased by $6.1 billion more than reported U.S. and U.K. liabilities. Some of these holdings represent dollars held by foreign monetary authorities outside the United States (i.e., in Eurodollars) or in this country through their commercial banks. Another part consists of reserves of French francs held by countries in the frac zones. The rest is comprised of various other currencies, much of which were accumulated as the counterpart of swaps. The United States, for example, held $99 million of convertible currencies at the end of 1962 and $2,781 million at the end of 1969.

INCREASE IN AGGREGATE RESERVES, 1963-70

[Million dollars]

	1963	1964	1965	1966	1967	1968	1969	1970
Total, all countries[1]	3,420	2,285	1,990	1,590	1,720	2,865	730	14,085
Gold	940	620	1,015	−950	−1,400	−565	190	−1,940
SDR's								3,125
IMF gold tranche	145	215	1,220	955	−585	740	240	970
Foreign exchange	2,330	1,455	−245	1,575	3,700	2,685	315	11,930
(U.S. liabilities)	(1,635)	(1,395)	(65)	(−835)	(3,365)	(−760)	(−1,515)	(7,340)
Total, excluding U.S. liabilities	1,785	890	1,925	2,425	−1,645	3,625	2,245	6,745

[1] Total, all members of the IMF. Data are rounded to nearest $5,000,000.

Source: International Financial Statistics, April 1971.

Thus, from 1963 to 1969, the total reserves of all members of the IMF increased by $14.6 billion of which about 22.9 per cent was in the form of U.S. liabilities to foreign monetary authorities. Much of the rest was the counterpart of reserve credits, including drawings on the IMF. For the entire seven years, the increase in reserves (without regard to their composition) was at an average annual rate of less than 3 per cent. Moreover, within this period the growth of reserves from year to year was very uneven. It was very large in 1963 ($3,420 million) and very small in 1969 ($730 million). The most important factor in the variation in the growth of reserves was the means of settlement of the U.S. balance of payments. Thus, reserves increased very much when the U.S. balance of payments was in deficit and settlements were made in dollars. But they also increased very much when the United States engaged in swaps and accumulated convertible currencies. On the other hand, in 1969, when the United States had a surplus on an official reserve basis, aggregate reserves increased very little because of a decline in U.S. liabilities of $1.5 billion.

Excluding the effect on aggregate reserves of U.S. balance of payments settlements in the form of foreign official holdings of U.S. liabilities, reserves of all members of the IMF increased by $11.2 billion from 1963 to 1969—an average annual rate of less than 2.4 per cent. Moreover, within this seven-year period, the change in reserves, excluding U.S. liabilities, varied from a decrease of $1,645 million in 1967 to an increase of $3,625 million in 1968. The decrease in 1967, excluding U.S. liabilities, was due to the sales of gold by the gold pool. This also accounts for the large increase in U.S. liabilities in that year, as the dollars accumulated by foreign monetary authorities were the counterpart of their share of gold sales to the private market. The very large increase in 1968, excluding U.S. liabilities, was mainly due to reserve credit operations of the United Kingdom with the IMF and foreign central banks, as U.S. liabilities actually decreased in that year. As these data indicate, the growth of reserves was very irregular and depended heavily on the state of the U.S. balance of payments, as well as reserve credit transactions of other countries and the IMF.

The growth of reserves in this haphazard fashion was a major weakness in the international monetary system, particularly as final reserve assets—those that could not be destroyed by conversion of foreign exchange into gold and by repayment of reserve credits—did not increase at all and became a progressively smaller part of total reserves. Moreover, the dependence of other countries on U.S. deficits for the growth of reserves could exercise pressures that would prevent the restoration of the U.S. balance of payments, although this was not significant as an independent cause of the U.S. deficit in recent years. These are the considerations that led to the agreement to create a new reserve facility, with the characteristics of a final reserve asset, that would assure a regular and adequate growth of reserves without depending on the balance of payments of the United States or of other countries. The Special Drawing Rights, of which $3,414 million were allocated in 1970 and another $2,949 million were allocated in 1971, were designed to be the means for the rational growth of reserves.

The experience of 1970 shows clearly that it is impossible to have an adequate but not excessive growth of reserves while the creation of reserves through the use of dollars in U.S. balance of payments settlements continues. On the basis of preliminary data, the increase in aggregate reserves of all members of the IMF was in excess of $14 billion in 1970. There was a decrease of about $1,940 million in their gold holdings, mainly because of subscriptions to the increase in IMF quotas, an increase of $970 million in the gold tranche position in the IMF, the issue of over $3.4 billion in SDRs, some of which were used for repurchases from the IMF, an increase of $7.3 billion in U.S. liabilities, and an increase of $4.6 billion in other foreign exchange, much of which may have been in Euro-dollars. Moreover, the increase in aggregate reserves in 1971 is likely to be about $9 billion of which nearly $3 billion will be in SDRs and perhaps $5 billion in U.S. liabilities to foreign monetary authorities. Unless a better control over the creation of reserves is exercised, there will be considerable opposition on the part of some large trading countries to further allocations of SDRs. This would be a backward step in the evolution of a rational international monetary system. Nevertheless, it must be recognized that some change in the method of creating reserves and settling balance of payments surpluses and deficits is inevitable.

At the annual meeting of the Governors of the International Monetary Fund in Copenhagen in September 1970, the Managing Director proposed that the United States settle a larger part of its deficit through the use of reserve assets

rather than through additions to foreign holdings of dollar reserves. The proposal was supported by a number of European countries. This is not a practical way of dealing with the haphazard growth of reserves resulting from sharp fluctuations in the U.S. balance of payments. Some countries prefer to hold dollar reserves, and even those that would prefer other reserve assets do not feel free to take the initiative in limiting their holdings of dollar reserves. Furthermore, a concerted attempt to present dollars for conversion into gold and SDRs might undermine confiidence in the dollar as a reserve asset and have widespread repercussions on the international monetary system. The proper way to change the reserve system is through an agreement that would apply equally to all countries.

RESERVE SETTEMENT ACCOUNT

There are a number of problems in connection with reserves that will have to be solved in the near future. The first is the haphazard growth of reserves, particularly in the form of dollars. The second is the growing preference for reserves in the form of gold and SDRs. The third is the harmonization in the use of different reserve assets, although not in present holdings. Finally, it would be desirable to make a clear distinction between final reserve assets which cannot increase or decrease and reserve assets which are the counterpart of reserve credit (including holdings of dollars) and therefore increase or decrease sharply with changes in the pattern of international payments and particularly the balance of payments of the United States.

The best way to deal with these problems would be to establish a Reserve Settlement Account, administered by the IMF, through which all international settlements would be made. Participating members of the IMF would earmark their reserves with the RSA in return for a corresponding balance denominated in a Composite Reserve Unit (CRU) having a guaranteed gold value of one dollar. International transactions would continue to be made in precisely the same way as now, with central banks intervening in the exchange market to keep exchange rates within the present limits above and below the parities agreed with the IMF. The sole difference would be that when countries acquire dollars or other foreign exchange through a balance of payments surplus, they would present the currencies for conversion into CRUs. And when countries require dollars or other foreign exchange for intervention in the exchange market because of a balance of payments deficit, they would present CRUs for conversion into these currencies. The present system of extending reserve credit through the IMF and swaps would be unaffected, but the counterpart of such operations would be isolated from the earmarked reserves in the RSA.

Gold.—All members of the IMF would earmark their gold holdings with the RSA in return for a balance of CRUs. Title to the gold, and even physical possession, would remain with the earmarking country. Thereafter, participating countries would not buy and sell gold for their currencies. Any member that has notified the IMF that it will "in fact freely buy and sell gold within the limits prescribed by the Fund" as a means of fulfilling its obligations regarding exchange stability (Article IV, Section 4) would withdraw its notification. The obligation of convertibility (Article VIII, Section 4) would be met by converting official balances of a member's currency either in the currency of the country making the request or in CRUs. Members countries would not, of course, engage in gold transactions in private markets, apart from selling newly-mined gold.

The IMF would also earmark its gold with the RSA in return for a balance in CRUs. Thereafter, members would pay the gold component of subscriptions to their quotas or increases in their quota (Article III, Sections 3 and 4) in CRUs. Repurchases of their own currencies (Article V, Section 7), where now required in gold, would be made in CRUs. Similarly, charges required to be paid in gold (Article VIII, Section 8) would be paid in CRUs. When the IMF finds it necessary to supplement its holdings of any member currency in connection with its reserve credit transactions, it would acquire the needed currency by buying it from the member with CRUs. In effect, wherever the Fund Agreement calls for the use of gold in transactions with members, it would be carried out in CRUs.

Thus, the present stock of monetary gold, whether held by member countries or the IMF, would be virtually fixed. The only changes in the monetary stock of gold could arise from purchases of newly-mined gold by the IMF under arrangements similar to those with South Africa. The IMF could also be authorized, in its discretion, to buy or sell gold from non-members; e.g., Switzerland, in connection with international settlements. Such purchases and sales would be based

on a fixed price of 35 CRUs per ounce, with payment made in CRUs. For convenience, the IMF could designate certain central banks, such as the Federal Reserve Bank of New York, to act as its agent in the purchase or sale of gold for CRUs with non-members. Purchases or sales of gold would be added to or taken from the earmarked account of the IMF. Non-members that engage in gold transactions with the IMF would acquire the CRUs through the conversion of member currencies and would use the CRUs for acquiring member currencies.

Foreign exchange.—All members of the IMF would earmark their foreign exchange reserves with the RSA in return for a balance in CRUs. The foreign exchange eligible for earmarking would be the official holdings of the major currencies used as reserves. These would include bank balances, open market paper, and government securities, both marketable and nonmarketable. Currencies held as the counterpart of clearing agreements, swaps, or other bilateral forms of reserve credit would not be eligible for earmarking. In effect, it is intended that all official holdings of dollars, sterling, and French francs by countries customarily holding reserves in these forms would be earmarked with the RSA. Each participating country would, however, retain an amount of such currencies needed for working balances, particularly for intervention in the exchange market.

The RSA would exchange the currency reserves it receives from participating members for the debtor country's nonmarketable demand notes having a guaranteed value in gold and bearing interest at a specified rate—say, 3 per cent per annum. The notes held by the RSA would become a fixed fiduciary reserve. Thereafter, no country would hold foreign exchange as reserves, except for working balances which would be permitted to increase at a rate agreed with the Fund and based on actual need. Such working balances would be held with the central bank, although arrangements could be made for holding some of the funds with commercial banks. It is worth noting that a similar provision was recommended by the Gold Delegation of the Financial Committee of the League of Nations. Participating countries would not hold balances of a currency in private markets outside the country, except as such holdings are incidental to transactions undertaken by international agreement for the purpose of regulating offshore money markets in these currencies.

While the earmarked foreign exchange would be a fixed fiduciary reserve, provision could be made for reducing the amount under exceptional circumstances. Thus, if the United States were to develop a persistent surplus, so that other countries experienced at a steady diminution of their CRU balances (excluding the amounts accruing from future issues of SDRs), the IMF could request the United States to encash some of its nonmarketable demand notes with CRUs. The IMF would then make a special issue of SDRs in an equivalent amount, allocate the issue to members, and add them to their earmarked SDR accounts, thus replenishing their balances in CRUs. The total amount of reserves earmarked with the RSA would be unchanged. The amount represented by earmarked dollars would be reduced and the amount represented by earmarked SDRs would be correspondingly increased.

Special Drawing Rights.—The SDRs issued by the IMF and allocated among its members would also be earmarked in the RSA in return for a balance in CRUs. Thereafter, new issues of SDRs would be placed directly in the earmarked accounts of the countries to which they are allocated. Thus, the only regular increase in aggregate reserves would come from new issues of SDRs, except for minor changes resulting from gold transactions of the IMF. The requirements that now govern the use of SDRs would be regarded as automatically fulfilled when settlements are made in CRUs. With the RSA, there could be no way of using SDRs in order to change the composition of reserves. When a country used CRUs in settling a payments deficit, it would automatically be using its other reserve assets along with SDRs in an equitable way. And when a country acquired CRUs in settling a payments surplus, it would acquire SDRs along with other reserves, precisely in the same way as if it had been designated by the IMF. As will be explained later, the rule regarding reconstitution of holdings of SDRs could be applied in accounting the implicit use of reserves in connection with transfers of CRUs. In fact, such a rule would be unnecessary if reserve transactions were exclusively in CRUs, and the present requirement of reconstitution could be dropped after the first basic period, in which it must be applied, comes to an end.

Reserve credit operations.—The operations of the General Account of the IMF, swap operations among member's and other extensions of reserve credit would be entirely outside the RSA. Thus, members of the IMF would continue to draw

the currencies they require for making international payments, subject to the rules that govern such drawings. Repurchases of their currencies by members (repayment of drawings) would be made in convertible currencies and CRUs, in accordance with the present provisions. Drawings of currencies would not add to the reserves held in the RSA as they would be used to make international payments or to replenish working balances. Similarly, member countries would be free to engage in swaps, although the currencies they hold as the counterpart of such operations would be designated as reserve credit assets. Such holdings would not be added to the foreign exchange reserves earmarked with the RSA, but they would not be regarded as contravening the limitation on the holding of foreign exchange.

Composition of reserves.—The basic reserves of the international monetary system would be those held as CRU balances and represented by earmarked gold, foreign exchange and SDRs. In adidtion to their CRU balances, all countries would customarily hold reserve assets in the form of working balances of the currencies they use for intervening in the exchange market and their gold subscription to the quotas of the IMF. The only other reserve assets would consist of the counterpart of reserve credit operations through the IMF, represented by the super-gold tranche, and foreign exchange acquired from swaps. These reserve credit assets of some countries would be equal to the reserve credit liabilities of other countries. Aggregate reserves would grow regularly through new issues of SDRs and the agreed increase in working balances of foreign exchange. The reserve assets acquired as a counterpart of reserve credit would increase and decrease in respect to such operations, but they would not be earmarked with the RSA.

TRANSACTIONS IN RESERVES

With the Reserve Settlement Account, all balance of payments surpluses or deficits on an official reserve basis would be settled (a) through transfers of CRUs, (b) through an increase or decrease in working balances within the limits of such holdings agreed with the IMF, (c) through drawings of member currencies from the IMF, and (d) through swaps and other reserve credit operations among members. Ordinarily, and over longer periods, the principal means of settling balance of payments surpluses and deficits would be through transfers of CRUs, as reserve credit operations would normally be reversed or repaid in less than three years.

A transaction in CRUs between one monetary authority and another (including those with the IMF) would involve an implicit transfer of the different reserve assets earmarked with the RSA. Thus, when a country pays out CRUs be-because of a balance of payments surplus, it would in effect be receiving settle-in gold foreign exchange and SDRs. Similarly, when a country receives CRUs because of a balance of payments surplus, it would in effect be receiving settlement in gold, foreign exchange and SDRs. The composition of the CRU transfers from cumulative deficit countries would differ from country to country, depending on the ratios of the various reserve assets it placed on earmark. The composition of the CRU transfers to cumulative surplus countries would be the same for all surplus countries, depending on the average of the ratios of the various reserve assets placed on earmark by the cumulative deficit countries.

The international monetary system would gain considerable strength from the establishment of the RSA. It would enable aggregate reserves to grow at a steady rate. It would eliminate the possibility of a disruptive preference for one reserve asset rather than another, and particularly the danger of a widespread shift from foreign exchange to gold and SDRs. The RSA would not attempt to harmonize the present composition of the reserves of countries. They would retain title to the gold, foreign exchange, an dSDRs they earmark. Changes in the present composition of reserves could occur only for cumulative surplus countries, excluding allocations of SDRs in calculating the surplus or deficit. Thus, predominantly gold holding countries would always have larger-than-average proportions of gold in their reserves, and predominantly foreign exchange holding countries would always have larger-than-average proportions of foreign exchange in their reserves. All countries, however, would have a growing proportion of SDRs in their reserves as new issues are made. Incremental changes in the composition of the gold, foreign exchange and SDR holdings would be the same for all cumulative surplus countries, as the implicit

transfer of such reserve assets would be the average of the ratios in which they were earmarked by cumulative deficit countries.

There would be only one qualification to the rule that cumulative deficit countries would implicitly transfer their reserves in the same ratios as they are earmarked with the RSA. The present rules regarding the use of SDRs require a country to reconstitute its holdings so that five years after the first allocation, and at the end of each calendar quarter thereafter, its average daily holdings of SDRs are no less than 30 percent of its average daily net cumulative allocations of SDRs over the same period. As this rule is mainly designed to assure a balanced use of all reserve assets, it would no longer be necessary if the RSA were established. Nevertheless, to meet the present rule, the implicit use of SDRs through drawing down the earmarked account of a deficit country with the RSA would not be allowed to fall below 30 percent of the cumulative allocations. Instead, the implicit use of other reserve assets would be correspondingly increased. After the first basic period, the IMF could eliminate this rule for participants in the RSA.

RESERVE ACCOUNTS OF CENTRAL BANK OF COUNTRY C

[Equivalent in million U.S. dollars]

ASSETS	
Earmarked account with RSA	2,500
Gold	1,500
Foreign exchange	750
SDR's	250
Cumulative surplus in RSA	500
Gold	150
Foreign exchange	250
SDR's	100
Balances of foreign exchange	325
Gold subscription to IMF	160
Additional creditor position in IMF	240
Due from other central banks	275
Total reserve assets	4,000
LIABILITIES	
Allocations of SDR's	250
Due to other central banks	150
Total reserve liabilities	400

The establishment of the RSA would not affect the manner in which central banks publish their reserve accounts. The CRU balance in the RSA could be shown in as great detail as desired. The initial reserves earmarked with the RSA could remain unchanged until there were new allocations of SDRs. Changes in the CRU balance would be shown as additions to or diminutions from the earmarked account. For a cumulative defiicit country, a decrease in its actual CRU balance below the amount earmarked with the RSA would be shown as a proportionate reduction in its holdings of gold, foreign exchange and SDRs. For a cumulative surplus country, an increase in its actual CRU balance above the amount earmarked with the RSA would be shown as an addition to its different reserve assets in the average ratios in which they were earmarked by the cumulative deficit country. The IMF could calculate daily the gold, foreign exchange and SDR components of the CRUs transferred to cumulative surplus countries. Other reserve assets would be shown in the usual way, although those arising from reserve credit operations with the IMF or with other countries would be identified as such. The table on page 10 is an example of how the reserve accounts of a creditor country could be presented.

It should be emphasized that no actual transfers of gold, foreign exchange and SDRs would be made from cumulative deficit to cumulative surplus countries. The entries on the books of the RSA would show the increase or decrease in the CRU balances of participating countries. If a country were to withdraw. however, a settlement of its CRU account would be made by the RSA under agreed provisions. The settlement with a cumulative deficit country would involve the return of gold, foreign exchange and SDRs to the amount of its actual CRU balance in the same proportions as these assets were originally earmarked by it with the RSA. The settlement with a cumulative surplus country would

involve the return of its earmarked reserves—the gold, foreign exchange, and SDAs to which it has title. A cumulative surplus country would also be entitled to settlement for its balance of CRUs in excess of its earmarked reserves. This payment would be made in gold, foreign exchange and SDRs in the average proportions in which they were earmarked by the cumulative deficit countries. When earmarked foreign exchange is returned to a withdrawing country, it would be in the currency or currencies that were earmarked. Additional foreign exchange to settle a cumulative surplus would be in the average ratios in which the separate currencies were earmarked by the cumulative deficit countries. The SDRs would be subject to the agreed settlement provisions.

The assets earmarked with the RSA would consist in part of gold and in part of fiduciary reserves—foreign exchange and SDRs. These fiduciary reserves earned interest when they were held separately by member countries and there is no reason why they should not earn interest for the holders of CRU balances insofar as they consist of such fiduciary reserves. It is proposed, therefore, that the RSA pay interest of 3 per cent on the foreign exchange component of a country's CRU balance. This is less than the market rate, but it can be justified as adequate because such assets in the RSA would have a gold value guarantee. Interest paid on net balances of SDRs in excess of a country's allocations would be at the rate of 1-½ per cent per annum or such other rate as the IMF may fix. The justification for a higher rate on the foreign exchange than on the SDR component of CRU balances is that the former represents reserve credit from all participating countries to individual countries while the latter involves a reciprocal obligation of participating countries to extend reserve credit to each other. The interest due a participating country on its CRU balances would be calculated on the daily average of its implicit holdings of foreign exchange and of SDRs in excess of its allocations.

ADVANTAGES OF THE RESERVE SETTLEMENT ACCOUNT

The Reserve Settlement Account would involve no basic change in the present method of engaging in reserve transactions, except that countries would earmark their reserve assets with the RSA and all reserve transactions would be in CRUs. Central banks would maintain the exchange rate for their currencies within the present limits by intervening in exchange markets with dollars, sterling or other currencies that they customarily use. For this purpose they would hold working balances of foreign exchange, but not in excess of reasonable amounts agreed with the IMF. Foreign official balances of all currencies would be convertible into CRUs and central banks would buy and sell currencies for CRUs when necessary to replenish working balances or to reduce excess working balances. Thus, the Federal Reserve Bank of New York would buy and sell CRUs for dollars in much the same way as it now buys and sells gold. Private holdings of and dealings in foreign exchange by business firms and commercial banks would continue as they now are, unaffected by the RSA.

The RSA would strengthen the international monetary system by providing for an orderly growth of reserves and by preventing disruptive preferences for some reserve assets rather than others. As balance of payments settlements would be made though transfers of CRUs, there could be no haphazard changes in aggregate reserves because of surpluses or deficits of the reserve currency countries or because of the conversion of existing balances of reserve currencies into gold and SDRs. Aggregate reserves could grow at a regular rate, neither too much nor too little, determined by the IMF through its allocations of SDRs. All of the different reserve assets would be used in international settlements in an equitable way without discrimination. Such gold as the IMF acquires through purchases of newly-mined gold would be held in its earmarked account with the RSA for the benefit of all holders of CRUs. The Bretton Woods system, which contemplates the adjustment of imbalances in international payments in a reasonable time, would function much more effectively if deficits had to be settled in reserve assets (CRUs) except to the extent that a member can secure reserve credit from the IMF and from other countries.

One of the advantages of the RSA is that it would sharpen the distinction between final reserve assets and those that are the counterpart of reserve credit operations. The currencies arising from reserve credit operations, whether the accumulation of additional working balances of foreign exchange, drawings of currencies from the IMF, or currencies acquired from swaps, would not become

part of the earmarked reserves. Thus, as reserve assets held outside the RSA they would be identified as resulting from reserve credit operations. Moreover, as official balances of foreign exchange would have to be held with central banks, such reserve assets of some countries would be identifiably offset by reserve liabilities of other countries. Indeed, it would be hoped that greater control would be exercised over the extension of reserve credit. Almost certainly, too much reserve credit has been available too easily in recent years.

The RSA would have important advantages for the United States and other reserve currency countries. True, the United States would not be able to settle its balance of payments deficits through accumulation of dollars by the monetary authorities of surplus countries. On the other hand, the establishment of the RSA would free the United States of the onerous obligation of converting existing official balances of dollars into gold and SDRs. Most important, this essential change would be accomplished not through unilateral action of the United States, but through an international agreement to make existing official balances of dollars a fixed fiduciary reserve in the RSA. Incidentally, the RSA would also provide a convenient means of terminating the reserve currency status of sterling, except for holdings of working balances, if this were regarded as a desirable prelude to its membership in the European Economic Community.

It may be objected that the United States would have greater difficulty in settling its balance of payments deficits if this had to be done primarily through transfers of CRUs. Even with the RSA, the United States would have considerable flexibility in meeting its payments deficits without a large depletion of its reserves. It would have an annual increment of SDRs from its allocations of new issues, and with the RSA such allocations would be larger than they would be without it—perhaps on the order of $1 billion a year or more. There would also be a regular increase of working balances held by foreign monetary authorities in dollars—perhaps at a rate of $500 million a year or more. Thus, if the United States could keep its average balance on an official reserve basis between zero and a deficit of $1.5 billion a year, it would not have a reduction in its reserves and, under favorable conditions, it could gradually replenish its reserves. In years in which the deficit was substantially larger than this average, much of it could be settled by drawing on the IMF and by making use of swaps.

The benefits derived by the United States from its position as a reserve currency country are in any case coming to an end. In one way or another, the large surplus countries will avoid accumulating dollars on the scale of recent years. To a much greater extent than in the past, they will present the dollar counterpart of their surpluses for conversion into gold and SDRs. And unless there is a marked improvement in the U.S. balance of payments, the present pattern of exchange rates will be changed, either through a depreciation of the dollar or an appreciation of other currencies. Whatever action other countries may take, it is certain to involve an end to the large-scale accumulation of dollar reserves to finance the U.S. payments deficit. The far-sighted policy for the United States would be to avoid such disturbing developments by supporting the establishment of a Reserve Settlement Account. Such action would strengthen confidence in the dollar. It would encourage the even wider use of dollars in international payments and international investment, a role that is far more important than a continuation of the present limping reserve currency role of the dollar.

From a broader view, the Reserve Settlement Account would contribute to the better functioning of the international monetary system. At present, the International Monetary Fund does not have powers to match its great responsibilities. With a Reserve Settlement Account under its administration, it would be the custodian of the reserves of its members. Through the issue of SDRs, it would control the growth of aggregate reserves. Through its General Account, it would be the principal and ultimate source of reserve credit for its members. With a RSA, the IMF would acquire more of the characteristics of an international monetary authority and it would have much greater influence over the policies that its members follow for adjusting their balance of payments. The members of the IMF should consider the advisability of establishing a Reserve Settlement Account.

Mr. Bernstein. One last word on the import surcharge. I regard the surcharge as very deflationary for the world. We ought to get rid of it. It is very uneven in its impact. It applies to half of all U.S. im-

ports, to around 75 percent of the imports from the industrial countries, and to over 90 percent of the imports from Japan. It does not apply at all to Russia and China. It doesn't apply to them because they are under the statutory rates of the Smoot-Hawley Tariff Act of 1930, and the surcharge cannot raise the import duty above the Smoot-Hawley rate. What we have done, though, is to wipe out all of the reciprocal reductions in tariffs on our side since the Reciprocal Trade Agreement Act of 1934 and right up to the Trade Expansion Act.

This seems to me deflationary. My own feeling is that the sooner we get rid of it the better. What we want is a United States with expanding production and employment. We want the rest of the world to see that we prefer to make the adjustment in our trade balance by increasing as far as possible our exports and not solely by squeezing our imports.

Well, I am sorry, Mr. Chairman, I didn't have this all written out.

Chairman PROXMIRE. No; it has been fascinating. You did a fine job and we appreciate it.

(The prepared statement of Mr. Bernstein was subsequently supplied for the record:)

PREPARED STATEMENT OF EDWARD M. BERNSTEIN[1]

DEPRECIATION OF THE DOLLAR

The decision of President Nixon to terminate the gold convertibility of the dollar and to permit the exchange rate to depreciate in foreign exchange markets was essential for strengthening the U.S. balance of payments and rebuilding confidence in the dollar and the international monetary system. This is widely recognized by other countries and many of them have in the past advocated such measures by the United States. As nearly all large industrial countries have a strong balance of payments and are well-supplied with monetary reserves, there is no reason why they should oppose an appropriate depreciation of the dollar. They would, however, prefer to see part of the depreciation accomplished through a reduction in the parity of the dollar; and they are opposed to the 10 per cent import surcharge even as a temporary measure.

The restoration of the U.S. balance of payments will require an increase in the balance on goods, services and remittances to a level adequate to finance U.S. foreign aid and U.S. net private capital outflow, after allowing for normal foreign capital inflow. The objective is to have a balance of payments on an official reserve basis in which there will be no further decline in U.S. reserve assets nor an unwanted increase in foreign holdings of dollar reserves. It should require a balance of about $8 billion a year on goods, services and remittances to achieve this, assuming no net change in long-term capital flows. As there was a deficit of about $1.2 billion in these accounts in the first half of 1971, despite the inadequate recovery of output and employment, it is obvious that a very large increase in the balance on goods, services and remittances will be necessary to establish a strong balance of payments for the United States.

Understandably, all countries are concerned as to how such an enormous change in the U.S. balance of payments will be brought about. While there will be some improvement in the service accounts, including investment income, by far the greatest part of the increase will have to be in the trade balance. The depreciation of the dollar will have to reverse the deterioration in the trade balance that occurred between 1964, when the surplus was $6.8 billion, and the first half of 1971, when the deficit was at an annual rate of $1.5 billion. Moreover, this large increase in the U.S. trade balance cannot be reached gradually over a period of years, but will have to be achieved in a relatively short period of time. Such a shift in the U.S. trade position will require great adjustments in the economies of other industrial countries that have become accustomed to very large

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[1] This statement, written by Edward M. Bernstein, was submitted for the record of the hearings of the Joint Economic Committee on President Nixon's program. Mr. Bernstein's oral testimony was given on September 1st.

exports to the United States. It will be much easier to make these adjustments in an environment of expanding world trade. For this reason, the depreciation of the dollar is a far more constructive way to increase the U.S. trade balance than the imposition of the 10 per cent temporary surcharge on imports.

The depreciation of the dollar will have uneven effects on the other countries. The less-developed countries will want to avoid any decline in the volume and prices of their exports. Those in the dollar area will probably retain the present exchange relationship of their currencies to the dollar. Those in the sterling area and in the franc zone will want the depreciation of the dollar in terms of their currencies to be as small as possible. In any case, the improvement in the trade balance will have to be almost wholly through an increase in exports and a decrease of imports of manufactured goods. The depreciation of the dollar, therefore, will be largely with respect to the currencies of the other industrial countries. Because of the differences in price competitiveness among them, in the strength of their own balances of payments, in the importance of their trade with the United States, and in the adequacy of their reserves, the depreciation cannot be the same in terms of the currencies of all these countries. Thus, the depreciation of the dollar makes it necessary to establish a new pattern of exchange rates for the currencies of the large industrial countries.

The central problem is to determine what the average depreciation of the dollar in terms of these currencies should be after the import surcharge is terminated. There are several ways of estimating the appropriate depreciation of the dollar. The deterioration in the U.S. trade balance was primarily due to the greater inflation in this country, particularly in the prices of exports of manufactured goods. Between 1964 and 1970, prices of such exports in terms of dollars rose by about 23 per cent in the United States, by about 9 per cent in Japan, and by about 13 per cent in Western Europe. The loss in price competitiveness for the other industrial countries have become more effective competitors of the United States in many manufacturing industries, quite apart from the change in relative prices. The depreciation of the dollar must offset not only the differential rise in prices, but the adverse change in the reciprocal supply and demand for exports and imports of manufactured goods. This would indicate that the depreciation of the dollar would have to be well over 12 per cent.

The problem can also be analyzed by considering the commodity composition of U.S. exports and imports and the response that might be expected to a depreciation of the dollar. In 1970, U.S. exports, excluding military grants, amounted to $42.7 billion on a census basis. About 45 per cent of the exports consisted of foods, feeds and beverages, and of industrial supplies and materials for which foreign demand is very inelastic in terms of price. U.S. imports amounted to about $40.0 billion of which about 53 per cent consisted of foods, feeds and beverages, and of industrial supplies and materials for which U.S. demand is very inelastic. The composition of exports and imports was not essentially different in the first half of 1971 when U.S. exports were $22.2 billion and U.S. imports were $22.6 billion, seasonally adjusted. Thus, the merchandise trade which would be expected to respond to a change in relative prices has been running at an annual rate of about $45 billion this year. Assuming an average price elasticity of 1.7 for such exports and imports, a depreciation of 13 per cent would be expected to improve the trade balance by about $8.5 billion. As U.S. demand for imports of foods and raw materials must be expected to increase proportionately with the expansion of output and income, a depreciation of close to 15 per cent will be necessary to secure a sufficient increase in the trade balance.

There is another test of the expected depreciation of the dollar. The import surcharge of a maximum of 10 per cent, along with the average depreciation of the dollar already realized, has probably raised the dollar cost of manufactured imports by an average of about 15 per cent. It will not be as much for goods subject to a slightly smaller import surcharge or for goods imported from countries with a smaller depreciation of the dollar, but it will be more for other goods subject to the maximum surcharge and imported from countries with a larger appreciation of their currencies. Having given U.S. manufacturers the benefit of such a change in price competition with import goods, the Administration is not likely to want it to be significantly less after the import surcharge is removed. This would seem to confirm the view that the average depreciation of the dollar will be on the order of 12 to 15 per cent after the surcharge is removed, and probably closer to the upper than to the lower limit of this range.

The depreciation of the dollar cannot be the same against the currencies of all industrial countries. As the pattern of exchange rates has been distorted by the action taken by several European coutries to avoid the further accumulation

of dollar reserves, the best point from which to measure the order of magnitude of the appreciation of other currences with respect to the dollar is the parities that existed at the beginning of May 1971. On the basis of the criteria already noted, the depreciation of the dollar in terms of the currencies of other industrial countries should be about in the following order, starting with the highest: Japan, Germany and Switzerland; Netherlands, Austria and Belgium; United Kingdom, France, Italy and the Scandinavian countries. The economic relations of Canada with the United States are so close and have such an enormous impact on the economy of that country that the best way to fit the Canadian dollar into a new pattern of exchange rates will be to adjust it to the appropriate level after the rates for the U.S. dollar are agreed in terms of the European currencies and the yen.

In the nearly three weeks since the dollar has been allowed to float, the average depreciation (measured from beginning of May parities) has been about 5 per cent in terms of the currencies of other industrial countries. The lag in the depreciation of the dollar is due to a number of factors. Until the yen was permitted to float, the Europeans were reluctant to see a greater appreciation of their currencies. While Europe can afford to yield its excessive competitive advantage to the United States, it is not in a position to give any further competitive advantage to Japan. Furthermore, all countries hesitate to allow their currencies to appreciate sufficiently until they know to what extent the depreciation of the dollar is to be achieved through an upward adjustment in the parities of their currencies and through a downward adjustment in the parity of the dollar.

Most important, it is not possible to have an adequate depreciation of the dollar so long as the import surcharge is in effect. With the surcharge, U.S. importers must limit their bid for foreign exchange, as a 12 to 15 per cent depreciation on top of the surcharge would mean a 22 to 25 per cent increase in the dollar cost of some imports. The foreign exchange market is dominated by the bids of importers who account for about 70 per cent of the demand for foreign exchange for current payments and over 50 per cent of the demand for all payments, including U.S. private foreign investment. Even large movements of short-term funds cannot offset the effect on the exchange rate of the sharp decline in the demand for foreign exchange by importers. For this reason, a new pattern of exchange rates with an appropriate depreciation of the dollar will have to be conditioned on the termination of the import surcharge.

While the appropriate depreciation of the dollar is probably between 12 and 15 per cent, any doubt as to the precise amount of depreciation should be resolved on the high rather than the low side. The prestige of the United States is not involved in minimizing the depreciation. It is involved in making the depreciation successful—that is, in establishing a strong balance of payments and in restoring confidence in the dollar. The rates that are now quoted in the exchange markets are not a measure of the depreciation necessary for the dollar, although they are a rough indication of the order of the appreciation there will have to be in the currencies of other industrial countries. As a practical matter, an appropriate depreciation of the dollar and a new pattern of exchange rates cannot be achieved solely through the operations of the exchange market, certainly not as long as the temporary import surcharge remains in effect. The amount of depreciation of the dollar in terms of the currency of each of the industrial countries will have to be agreed by the United States with them and in consultation with the International Monetary Fund.

REVALUATION AND DEVALUATION

These are difficult problems, as the industrial countries will be concerned not only with the extent of the appreciation of their currencies relative to the dollar, but with the relationship this will involve for their currencies in terms of each other. Even when an understanding on a new pattern of exchange rates has been reached, it will be necessary to come to an agreement on how much of the depreciation of the dollar and the differential appreciation of other currencies should be achieved through an upward change in the parities of some currencies and a downward change in the parity of the dollar. For international trade and payments, the depreciation and appreciation of currencies are decisive, not the changes in parities. Nevertheless, there are some practical aspects of the revaluation-devaluation alternatives that cannot be ignored.

The depreciation of the dollar will involve great adjustments in the export industries of other industrial countries. The exporters in these countries want the appreciation of their currencies to be as small as possible. If some countries, such

as Germany and Japan, had to raise the parities of their currencies more than 15 per cent, they would face serious opposition at home. On the other hand, if the parity of the dollar is simultaneously reduced, so that their revaluation need not be more than 8 to 10 per cent, they can take the view that to this extent the depreciation of the dollar is beyond their control. To put it plainly, if the depreciation of the dollar must be achieved solely through a revaluation in the parities of other currencies, the parity of the dollar remaining unchanged, the average depreciation will be considerably less than is necessary to establish a strong balance of payments for the United States.

The present distortion in exchange rates is mainly the result of the persistent deficit in the U.S. balance of payments. The United States has an obligation under the Bretton Woods Agreement to correct this as far as possible through a devaluation of the dollar. Because the depreciation cannot be the same with respect to all other currencies, a change in the parity of the dollar alone will not restore an appropriate pattern of exchange rates. Revaluation of the parities of some other currencies will be necessary in any case. The number of changes in parity can be kept to a minimum, however, if some of the adjustment of exchange rates is made through a devaluation of the dollar. If the dollar were devalued by 7 or 8 per cent, no change in parity might be needed at all for sterling, the French franc, the Italian lira, and the currencies of the Scandinavian countries. That is to say, with a moderate develuation of the dollar only half as many changes in parity will be necessary in order to achieve an average depreciation of 12 to 15 per cent in the exchange rate for the dollar.

All sorts of reasons will be put forward against a devaluation of the dollar. It will be said that the Congress will never approve an increase in the dollar price of gold. It will be urged that this involves penalizing the countries that held dollars as reserves instead of converting them into gold. It will be argued that this will be a windfall for Russia, South Africa and the gold speculators. These are not economic reasons and they have no economic merit. They reflect ideological prejudice and good policy cannot be made on such a basis. A devaluation of the dollar is in the interest of the United States and all other countries, and it is necessary to prevent a decline in the value of the monetary reserves of the entire world, including those of the United States.

There may be opposition in the Congress to raising the monetary price of gold from $35 to $37.80 an ounce (a devaluation of 7.4 per cent). The opposition will be partly due to the view that the $35 price is somehow sacred, but mainly to a fear that it would enhance the monetary role of gold. Actually, there is no law that sepcifically sets the price of gold at $35 an ounce. The Gold Reserve Act of 1934 authorized the President to set the content of the gold dollar between 50 and 60 per cent of its old content—that is, at a price between $34.45 and $41.34 an ounce. By Executive Order, the President fixed the content of the dollar at 15 5/21 grains of gold, nine-tenths fine—that is, at $35 an ounce. The Bretton Woods Agreement Act does specify that no change in the gold parity of the dollar shall be proposed to the IFM without the prior authorization of the Congress.

If the Congress were to take the view that all changes in the foreign exchange value of the dollar must be made entirely by changes in the parities of other currencies it would be abdicating its Constitutional prerogative. Article I, Section 8 of the Constitution states: "The Congress shall have power . . . to coin money, regulate the value thereof, and of foreign coin." The United States is now in the midst of making the most important change in the dollar since the Great Depression of 1933, when the Congress authorized the President to devalue the dollar. Yet this change of up to 15 per cent in the foreign exchange value of the dollar, taken on the initiative of the Executive Department, could be made without any action of the Congress if ideological prejudice were to forbid, now and forever, any reduction in the gold parity of the dollar.

The declaration of a new parity for the dollar does not enhance the monetary role of gold. The sole purpose of declaring a parity in gold is to have a common denominator for all currencies—a measure of the par of exchange between the dollar and other currencies. It does not involve any obligation to buy or sell gold. In fact, now that the United States has withdrawn its commitment to the IMF, no country has accepted the obligation to buy and sell gold freely and no country ever will. Of course, it would be possible to declare parities in units of SDRs if the Fund Agreement were amended, but the unit of value of SDRs is already defined as equal to 0.88671 grams of fine gold—that is 35 SDR units to an ounce of gold. It would be nonsense to declare a new parity of the dollar

in terms of SDRs and to pretend that this is not the same as a devaluation in terms of gold. The United States cannot allow itself to engage in such sophistry.

The view that devaluation would be unfair to countries that hold dollar reserves is not correct. The real loss sustained by the holders of all reserve assets (gold, dollars and SDRs) came from the inflation in the United States and other countries that reduced the purchasing power of reserves in goods and services. The depreciation of the dollar will reduce the value of the dollar in terms of foreign currencies—that is, in paying for imports from Europe and Japan. The loss in the foreign exchange value of dollar reserves is precisely the same whether it is done through a revaluation of other currencies, a devaluation of the dollar, or partly in one and partly in the other. Even then, it is questionable whether the countries that decided to hold dollar reserves are worse off than those who chose to hold gold reserves. With the high yields on U.S. Treasury bills, any country that held dollar reserves would have earned more than enough interest since January 1970 to offset an 8 per cent devaluation of the dollar. For dollar reserves held since mid-1968, interest earnings would have compensated not only for the devaluation of the dollar, but even for a 15 per cent average depreciation of the dollar in terms of foreign exchange.

All holders of reserves would benefit from a devaluation of the dollar. If the depreciation of the dollar is achieved entirely through a revaluation in the parities of other currencies, the reserves of the world would be virtually unchanged in dollars, but would be sharply reduced in terms of the currencies of the other industrial countries. On the other hand, if the depreciation of the dollar were achieved by a devaluation of the dollar and an equal average revaluation of other currencies, the reserves of the world would be increased in terms of dollars, although there would still be a decrease in terms of the currencies of the other industrial countries. The average monetary value of all reserves in terms of dollars and other currencies would fall very little.

EFFECT OF DOLLAR DEPRECIATION ON VALUE OF AGGREGATE RESERVES

[Billion dollars or equivalent in other currencies]

	Value on June 30, 1971	Value with dollar parity unchanges [1]		Value with dollar devaluation [2]	
		Dollars	Other currencies	Dollars	Other currencies
Gold	$37.0	37.0	31.5	40.0	34.3
SDR's	5.9	5.9	5.0	6.4	5.5
Reserve position in IMF	6.9	6.9	5.9	7.5	6.4
U.S. reserve liabilities	33.7	33.7	28.7	33.7	28.7
Other foreign exchange [3]	20.5	22.1	19.0	21.3	19.7
Total	104.0	105.6	90.1	108.9	94.6

[1] 14.8 percent average depreciation of the dollar through revaluation of other currencies.
[2] 7.4 percent devaluation of the dollar (8 percent rise in the dollar price of gold) combined with an equal average revaluation of other currencies.
[3] Sterling, French francs, Deutsche marks, and other currencies, including Eurodollars and U.S. reserve liabilities denominated in foreign currencies. Half of the total amount is assumed to be affected by revaluation and devaluation.

Aggregate reserves of all countries were about $104 billion at the end of June 1971. They are considerably larger now, but they will probably revert to about that level when funds start moving back to the United States. A 14.8 per cent rise in the average parities of other currencies would result in a reduction of the equivalent of $14 billion in the value of reserves in these currencies. On the other hand, a 7.4 per cent devaluation of the dollar (an 8 per cent rise in the dollar price of gold) and an equivalent revaluation of other currencies would increase the dollar value of reserves by $5 billion and reduce the value of reserves in other currencies by the equivalent of $9 billion. Of the $5 billion increase in the dollar value of reserves, nearly $1 billion would accrue to the United States. Moreover, a revaluation of other currencies by 14.8 per cent would reduce the value of the quotas in the IMF in these currencies by the equivalent of more than $4 billion. A devaluation of the dollar by 7.4 per cent would raise the dollar quotas of all countries by about $2.3 billion and the quota of the United States by over $500 million.

The most popular argument against the devaluation of the dollar seems to be that it will benefit the Soviet Union, South Africa and the gold speculators. This

is not correct. The Soviet Union has not sold gold to foreign monetary authorities since 1945. With the free market price for gold well above the monetary price, the Soviet Union could not benefit from a moderate increase in the monetary price of gold in terms of dollars. South Africa has sold small amounts of gold to the IMF at the monetary price. These sales were made not for the purpose of reducing supplies in the free market but to establish the position of gold as a monetary reserve asset which the IMF buys for currencies. Total purchases of gold for currencies by the IMF in the first half of 1971 amounted to $102.6 million of which $12.6 million was paid for in dollars. The termination of the U.S. undertaking to buy and sell gold will almost certainly lead to fundamental changes in the present system of holding and using reserves, and this will result in a far-reaching change in the monetary role of gold.

Speculation in gold is based solely on the expectation that a breakdown of the international monetary system will ultimately lead to a restoration of the old gold standard. In order to have enough reserves for such a system, speculators believe that the price of gold will have to be doubled in terms of all currencies. Every monetary crisis results in a rise in the free market price of gold because speculators hope that the breakdown of the international monetary system is that much nearer. Every resolution of the crisis results in a fall in the free market price of gold because it shows that international monetary problems can be solved without a large and uniform increase in the monetary price of gold. In the present crisis, the free market price of gold rose sharply before the announcement of the depreciation of the dollar, but then fell considerably. A moderate devaluation of the dollar would end all hope for a large and uniform increase in the monetary price of gold. If it were also agreed to reform the reserve system, the unique monetary role of gold would be ended, and speculation in gold would be based solely on its price behavior as another commodity.

REFORM OF THE INTERNATIONAL MONETARY SYSTEM

The recurrent crises are evidence that the Bretton Woods system of fixed parities and of reserves composed of gold and dollars has not worked well in recent years. This is not because of inherent defects in the system. In fact, the Bretton Woods system provided greater flexibility than ever before for balance of payments adjustment without requiring inflation in surplus countries or deflation in deficit countries. Until a few years ago it would have been generally accepted that the Bretton Woods system had been outstandingly successful in creating an international monetary system well suited to an expanding world economy.

The Bretton Woods system was based on two assumptions. The first was that international monetary stability would be achieved if the United States maintained a high level of production and employment without inflation and if other countries regarded the maintenance of the foreign exchange rate for their currencies in terms of the dollar as one of the major objectives of economic policy. Thus, the United States was expected to discipline itself and other countries were expected to be disciplined by keeping in step with the United States. The second assumption was that the reserve needs of other countries could be met from newly-mined gold supplemented by a redistribution of U.S. gold holdings and through the gradual accumulation of dollar reserves. Short-term needs of deficit countries would be met through reserve credit provided by the IMF. In fact, an adequate growth of reserves could not be secured indefinitely through the limited increases in gold production and the continued impairment in the reserve position of the United States.

The system of fixed parities, subject to change after consultation with the IMF and with its approval, worked very well so long as the United States avoided inflation and had a strong balance of payments for a reserve center. Countries that had persistent payments deficits were expected to devalue their currencies, and the United States was foremost among those urging that such adjustments should be made promptly. There was only one case of a large industrial country that found the system of fixed parities onerous. In 1950, Canada decided to cut the tie to parity and to allow the Canadian dollar to appreciate in a free market. Even then, the real purpose was to minimize the effect of the impending inflation in the United States because of the Korean war. Until recent years, no country argued that the system of fixed parities with a limited range of exchange rates hampered balance of payments adjustment.

Doubts about the functioning of the system of fixed parities came only with the inflation in the United States and the sharp deterioration of the U.S. balance of payments after 1965. While the academic community had long had advocates of greater flexibility of exchange rates, Governments and central banks did not regard this as a practical policy until late in 1968. Even then, their main concern with greater flexibility of exchange rates was to find a means of avoiding the trnasmission of inflation from the United States. As I concluded in a paper on Flexible Exchange Rates and Balance of Payments Adjustment (68/24): "If the international monetary system is not to have an inflationary bias with flexible exchange rates, it would be necessary to have a strong dollar and a stable and prosperous U.S. economy. Of course, if the Unitde States could achieve this there would be much less reason for changing the present system of fixed parities."

At Bretton Woods, the U.S. delegation proposed that the range of exchange rates be 2 percent above and below parity. Perhaps an even wider range of 3 percent could be useful in minimizing non-equalibrating short-term capital movements. A gradually moving parity could be useful, but only in a limited degree. Where a country's international payments position is being eroded by a deterioration in its real international economic position, apart from competitive prices, a gradual devaluation of its currency by 1 or 2 percent a year could keep the balance of payments in order. Neither wider margins nor gradually moving parities would be of much use where a country has a large deficit because of a prolonged inflation which permanently alters its price competitiveness in world markets.

The other essential change in the Bretton Woods system is to establish a rational method of holding, using and increasing reserves. Until about 1958, the reserves of other countries did grow adequately through the acquisition of newly-mined gold and limited redistribution of the reserves of the United States. From the end of 1950 (after the devaluations of 1949) to the end of 1957, the reserves of all countries other than the United States increased by about $3.7 million in gold and by about $4.2 billion dollars. In the same period, the reserve assets of the United States increased by $40 million in gold (to $22.9 billion) and by $520 million in the U.S. position in the IMF. Nevertheless, it was already evident that this method of providing reserves could not continue indefinitely. At a seminar at Harvard on October 17, 1958 (58/13), I said:

"The increase in reserves that can come from newly-mined gold and a payment surplus with the Communist bloc is probably quite limited during the next few years. Any substantial improvement in the reserve position of other countries can come only from a reduction in U.S. gold holdings and an increase in foreign official dollar balances. While the reserves of the United States are adequate to allow for some decline in its gold holdings and a considerable increase in foreign official dollar balances, this is not the best way of meeting the long-run problem of reserves. The time has come to place the growth in world reserves on a more rational basis, related to the new institutional developments and to future needs."

The establishment of Special Drawing Rights has provided a new reserve asset that could become the means for assuring an adequate but not excessive growth of reserves on the basis of the trend needs of the world economy. This is not possible, however, as long as there are large fluctuations in the dollar reserves of other countries. Since 1966, the dollar component of reserves has varied sharply—increasing by $3.3 billion in 1967, decreasing by $3.4 bilion to mid-1968, and increasing by $9 billion to the end of 1970 and by a further $10 billion in the first half of 1971. The growth of reserves cannot continue to depend on deficits in the U.S. balance of payments. Furthermore, the unique role of gold as the only final and unlimited reserve asset has become a seriously destabilizing factor in the international monetary system. The ability of countries to alter the composition and use of their reserve assets—the preference for gold and SDRs over dollars and other foreign exchange—could lead to massive conversions of existing foreign exchange reserves and disrupt the international monetary system.

Since 1967, I have been urging that the reserve system be rationalized by having countries earmark their gold, SDRs, dollars and other foreign exchange in a Reserve Settlement Account administered by the IMF. Countries would be given a credit balance equivalent to their earmarked reserves in the form of a Composite Reserve Unit (CRU). All transactions in reserves would thereafter be through transfers in the Account. A country with a deficit would run down

its CRU balance, implicity reducing its different reserve assets in the proportions in which they were earmarked in the Account—that is, the same proportions of gold, SDRs, dollars and other foreign exchange as it held. A country with a surplus would build up its CRU balance, implicitly increasing its different reserve assets in the average proportions in which they were earmarked in the Account by the deficit countries. Thus, countries would no longer be able to alter the composition of their reserves. They would be required to use and accept the different reserve assets without discrimination between gold, SDRs and foreign exchange.

Under this system, no country would any longer buy and sell gold for its currency. As payments deficits would be settled only through the Account, there could be no increase or decrease in the dollar component of reserves. If the United States had a deficit, it would have to meet it through use of its balance in the Account or through use of reserve credit from the IMF or from other countries. For the United States, such a system would have the advantage of ending the possibility of massive conversions of outstanding dollars. For the other countries, it would have the advantage of ending the unlimited creation of dollar reserves by the United States to finance any future deficits on an official reserve basis. The necessary growth of aggregate reserves would come solely from the issue of SDRs.

The establishment of a Reserve Settlement Account would involve no basic change in the present methods of dealing in foreign exchange. There would be no limitations on private holdings of dollars. They would remain freely convertible into other currencies through the exchange market. The accumulation of additional dollar reserves by monetary authorities, however, would be limited to the necessary increase in working balances. Countries requiring additional dollars for intervention in the exchange market would sell CRUs to the United States, just as they have hitherto sold gold. And countries acquiring excess dollars that they have taken out of the exchange market would convert them into CRUs, just as they have hitherto converted dollars into gold. The United States would have the obligation it now has of converting official holdings of dollars, but such conversion would be made at the option of the United States either in CRUs or in the currency of the country requesting the conversion, and never in gold.

U.S. POLICY AND THE WORLD ECONOMY

The United States should make it clear to all countries that the sole purpose of the measures it has taken is to establish a strong balance of payments and to restore confidence in the dollar. That will require a depreciation of the dollar and a new pattern of exchange rates. The depreciation of the dollar will have far-reaching effects on the economy of the United States and those of other countries. In the United States, the increase in the trade balance will act as a stimulus to recovery in much the same way as an increase in domestic investment. In other industrial countries, the decrease in their trade balance will reduce aggregate domestic demand and compel adjustments in their export industries. In a few countries where there is a demand inflation, the reduction in the trade balance will not be unwelcome. In other countries, the reduction in the trade balance will necessitate an expansion of domestic demand. Even with such policies, the adjustment will be difficult for other industrial countries and especially for those with the closest trade relations with the United States.

Unless the large industrial countries follow expansionary policies, the depreciation of the dollar may lead to a contraction of world trade. The experience of the past is that world trade grew rapidly when U.S. imports increased considerably and stopped growing for a year or two when U.S. imports declined. If the depreciation of the dollar were to halt the growth of world trade, even temporarily, it would be harmful not only to other industrial countries but to the less-developed countries as well. Thus, the objective of the United States should be to see that the improvement in its trade balance is accomplished as far as possible through an increase in exports rather than a decrease in imports. All countries can help in avoiding a contraction of world trade by maintaining a high level of domestic demand and by reducing restrictions on imports. For the United States, this would require an accelerated recovery and termination of the import surcharge.

The most constructive way to restore the U.S. balance of payments is through the depreciation of the dollar. While it would probably not reduce U.S. foreign investment, particularly if the restrictions on direct investment are relaxed, it

would improve the service accounts as well as the trade account. Most important, a depreciation of the dollar would stimulate exports as well as restrain imports. Furthermore, if the recovery in the U.S. economy is accelerated, the increase in output and income will moderate the reduction in imports as a result of the depreciation of the dollar. On the other hand, the import surcharge places almost the entire burden of adjusting the U.S. balance of payments on the restriction of imports. As the surcharge also limits the depreciation of the dollar, it holds back the expansion of exports.

The import surcharge is unfair, but has an uneven incidence, and undermines the hitherto successful efforts to reduce barriers to the expansion of world trade. The surcharge applies to dutiable imports from the less-developed countries, even though the United States has no desire for a change in either their currency or trade policies. It does not apply at all to Russia or China and is a heavy burden to the countries that trade most with the United States. Although less than half of all U.S. imports are subject to the surcharge, about 93 per cent of the imports from Japan are under this penalty. The import surcharge raises all U.S. tariffs, except where there are statutory quota restrictions, in many instances to the level of the Hawley-Smoot Tariff Act of 1930. It wipes out most of the reductions in tariffs negotiated since the first reciprocal trade agreements in 1934. If other countries took countervailing measures, the world economy would be back to the disastrous trade restrictions of the 1930s.

The imposition of the import surcharge is a denial of the principle of international cooperation on monetary and economic affairs. Until the surcharge is terminated, it will be impossible to have an adequate depreciation of the dollar or to establish an appropriate pattern of exchange rates among the large industrial countries. The import surcharge will inevitably hamper the negotiations for reforming the international monetary system. The early removal of the import surcharge is in the interest of the United States and of the entire world.

Chairman PROXMIRE. Mr. Okun, I want to get back to your remarkable specific recommendation and I want to congratulate you on it.

There is a tendency on the part of many witnesses to be very vague and not give us specific recommendations of the kind you have, and I think it is most helpful because it does provide a basis on which we can discuss it.

You suggest a 5-percent increase possibly in wages or possibly 5 percent plus. In the first place, how realistic is this in terms of the attitude organized labor might take where they have contracts that would call for a larger increase, contracts that are freely made between labor and management, that have been agreed to?

In the first place, do you think it would be constitutional to abridge those contracts, in the second place, is it realistic to expect labor to accept a lesser amount?

Mr. OKUN. I was really looking forward, Senator Proxmire, and I think the question of whether one lets bygones be bygones or whether one wishes to abrogate or modify previous contracts is really a separate question.

I would hope that, if we looked at what is in store from second and third rounds of previously negotiated contracts, we would find we could live with that and, consequently, would not need to abrogate contracts that were made in good faith previous to August 15. I think that is really the dividing line. It seems to me that once we adopted the freeze, there were new rules of the game and, in that sense, contracts after August 15 should have taken account of the probability of Government action.

Most of the large wage settlements made in recent years have been remarkably frontloaded. That means a very substantial portion——

Chairman PROXMIRE. Most of them have been but some that have not been.

Mr. OKUN. Yes; I know some examples where they have not.

Chairman PROXMIRE. I think the Teamster's contract calls for a substantially larger settlement.

Mr. OKUN. I believe that is the case. I heard of one example of airline machinists who have 5 percent coming every 6 months for the next 18 months. I think——

Chairman PROXMIRE. With respect to those contracts then, do I understand you to say you would accept that because the contracts were made prior to August 14 or do you think we should make an attempt to try to negotiate them?

Mr. OKUN. I think it is a matter of what their quantitative importance is. I would say both in terms of administering the system, in terms of minimizing compulsion, in terms of wanting to insure that people who were playing by the rules of the game that prevailed prior to August 15 should not be penalized, that I would prefer to see us live with a few unhappy wage increases that might lead to a few unhappy price increases.

Chairman PROXMIRE. Let's move into the other phase which it would seem to me represented one weakness of the wage-price guidelines in 1962 to 1966, and that is the administration of prices. It was ncessarily rather vague and indefinite. The hope was that some prices would be reduced, others would remain stable, we would have average productivity, and others would be expected to increase. If you have a different standard, not 3.2 but 5 percent, it seems to me you complicate your problem, make it even more difficult to maintain prices or to expect to get any kind of price reductions. Won't there be a great difficulty in enforcing this? It is one thing to freeze prices or to say they won't go up above a certain base and something else to say they will go up a certain amount, and even more difficult to say where you have productivity which is less than average they can go up more and productivity more than average they go up less. Is this really a practical, realistic basis for administering an inflation control program?

Mr. OKUN. I think you are pointing to a real problem. The absence of price reductions in many industries with unusually high productivity growth in 1964 and 1965, I think, was one of the contributing factors to the breakdown of the guideposts.

Actually, looking at the present average of 4- or 5-percent price increases, price reduction looms more as a hope of the future than as a reality of the present. This may be a problem that we will get into as we are more successful. It will be important to get some downward flexibility in the prices of industries with very high productivity growth.

Chairman PROXMIRE. Then it seems to me we should put a great emphasis and great importance on the expertness and the capability of a wage-price review board, of having a number of them that would specialize in various industries and understand the cost problems of the industry and so forth and would administer them with considerable care and competence, does it not?

Mr. OKUN. Yes. But nonetheless I think that could be a fairly small compact staff fitting into a single floor of a typical Washington office building.

First of all, I think it was Otto Eckstein who made the point, that if you gave him control of 50 to 100 prices and 50 to 100 labor con-

tracts in a year most other things would take care of themselves. These visible items not only have a major impact on the cost of living and the average of labor cost increases but they also determine the atmosphere, they set the pattern, which other people feel they have to or are able to follow.

Nonetheless, I would be reluctant, as I have indicated, to say these are the included items and everything else is excluded. I think we should say these are rules for all Americans. The enforcement and administration obviously would focus on those things that are tremendously significant and not try to look over the shoulder of every retailer or every small manufacturer.

Chairman PROXMIRE. Would you agree with Gardner Ackley who suggested that all rents be decontrolled, that all retail prices be decontrolled, and, except for maybe large ticket items, that the controls be confined to a few large corporations and primarily the big labor unions?

Mr. OKUN. Well, as I have expressed this, everything would be decontrolled when the new program is put into effect, and the intention would be to say, "Here are the rules of the game. We are setting them forth. You read them, you understand them. They are rules for the attention of all Americans. Whether you are big or small, you ought to pay attention to this, but we are not invoking legal sanctions at this point. However, the legal sanction is there in the right to freeze any price or any wage, back as far as May 25, 1970, and if a price increase or wage increase seems to be a flagrant violation of the standard of major consequence to the Nation, then the Government will suspend that increase, and develop a procedure to make a determination. If it is finally determined that it has been a flagrant violation, that price or wage will be rolled back and held frozen for some substantial period. There is no control at the present. The control comes in insofar as you behave in ways that raise serious questions about violations of playing by the rules of the game."

Chairman PROXMIRE. Then it is very important that the rules of the game be explicit and clear and definite, that you have a specific limitation on wage increases and that you have, it might be quite complicated but you have a limitation on price increases that would give you an overall effect of only 1 or 2 percent increase over the price level; is that correct? You think it is possible from your study of the economic system to work that out in our system?

Mr. OKUN. Let me put it this way: I would suspect that because of the complexity of many price and wage decisions—such as fringe arrangements in labor contracts or the pricing of changed or new products, there would be cases where the rules of the game couldn't determine whether the ceiling wage increase was 30 cents an hour or 32 cents an hour or whether the standard would point to a price increase on a refrigerator of $3 or $3.50. But it could guide reasonable men within a narrow range, and it would let people operate. Basically when you post a 50-mile speed limit, you don't pick up speeders because they happen to be going at 51 or 52, but you don't promise them exemption either. I think it is in that sense that you can spell out a set of rules that confine the range of debate within a very narrow area.

There would be a little slippage somewhere and, I am reluctant to use a 1- or 2-percent target for that reason. I think, first of all, there

are some catch-ups of costs from the past year which business may still have to pass on even under a partial cost absorption rule. There may be some slippage, in the processing of raw materials. But I think you can come close enough. I think it is possible to monitor the price standard effectively in such a way that it does not create inefficiency and does not create a tremendous amount of bureaucracy or recordkeeping.

In a little exercise in arithmetic that I performed after 1969, I showed that 19 industries which had displayed some cooperation with the jawboning of the Johnson administration in 1966–68, accounted for about a quarter of the total industrial wholesale price index. So a tremendous scope is not needed in order to get effective control and in order to change the basic atmosphere in this country from one of inflation to one of essential price stability.

Chairman PROXMIRE. And the reason why you think this will work and why the 1962–66 guidelines eventually broke down, I take it, is we now have excess demand, we have a surplus of plant capacity labor, we have plenty of people who want to perform work and under these circumstances if we can break the wage-push element of inflation, you think the 5 percent would do that, that the general economic situation would take care of controlling the rest of it; is that right?

Mr. OKUN. That is a precise statement of the way I feel. I think the demand situation really was the key element in 1966. Up to mid-1965, we didn't fully achieve the goal of price stability but the performance was certainly something that everybody could live with. We didn't get an average of 3.2 percent on wages, we may have gotten an average of 3.8 percent. We didn't get zero on prices, we got something like 1 percent. That much slippage is tolerable, it does not redistribute income from group to group in any significant way, I believe that an imperfect target, which still represents a major improvement from where we are now and where we have been in the last several years, is quite feasible under a system which minimizes the scope of legal sanction and compulsion.

Chairman PROXMIRE. My time is up. Congressman Conable.

Representative CONABLE. Thank you, Mr. Chairman.

Mr. Okun, I go down to the Brookings Institution quite a bit and I think Brookings makes valuable contributions to the Government. A great many people from Brookings come before this committee and I am wondering are there any Republicans down there?

Mr. OKUN. Yes; there are.

Representative CONABLE. Do they ever come up and appear before committees?

Mr. BERNSTEIN. They eat lunch there.

Representative CONABLE. They eat lunch there. [Laughter.]

Mr. OKUN. They are in the minority, Mr. Conable.

Representative CONABLE. I beg pardon.

Mr. OKUN. They are a minority. I think it is——

Representative CONABLE. I suppose it is no different from any other educational institution in that respect.

Mr. OKUN. I once heard Paul McCracken say very casually that is was his guess that 90 percent of the economics profession in this country are Democrats. He was making that point that he had a tougher time recruiting than I used to have because a much smaller fraction of the profession is Republican.

Representative CONABLE. I ask that question in all seriousness although I am not in any way implying partisanship on your part. However, we have had a number of Brookings people who have been past administration officials and I was wondering if there was more than coincidence in that respect.

Mr. OKUN. One obvious point is that both Herb Stein and Dick Nathan, who are now officials in the Government and are Republicans obviously, are on leave from Brookings.

Representative CONABLE. I am pleased to hear there are some Republicans in the Government now. I didn't know whether there were. [Laughter.]

Mr. OKUN. I was going to suggest if we tried an experiment whereby we restored a Democratic President, I think you would find the complexion of Brookings by political party changed dramatically.

Representative CONABLE. I am not sure whether I look forward to this or not. [Laughter.]

Let me ask you about some of the rhetoric in your statement about——

Mr. OKUN. OK.

Representative CONABLE (continuing). The tax proposals. For instance, you say $8 billion of the incentives for production go to business equipment and automobiles.

Now, of course, the investment tax credit is a specific for business equipment. It is also of tremendous value to agriculture; is it not? It is of tremendous value to anybody who uses the machine, the tools of production; isn't that correct?

Mr. OKUN. It has value to the buyer of the equipment but looking at it in terms of its incentives to production, I would stand on my interpretation, that it is primarily, initially and directly an incentive to production in equipment industries.

Representative CONABLE. Yet I get the impression from your statement you favor that over the accelerated depreciation.

Mr. OKUN. You read very correctly.

Representative CONABLE. Well, now, isn't it true that the investment tax credit would be of considerably greater value to business than accelerated depreciation in terms of the immediate impact on profits?

Mr. OKUN. Well, in the sense that——

Representative CONABLE. On net profits I am talking about. Isn't that more of a giveaway to business than the accelerated depreciation, if you look at these things as giveaways?

Mr. OKUN. Dollar for dollar, I really do not see—giveaway is your word—that there is any difference in the giveaway. There is a difference in the effectiveness of the stimulus, and——

Representative CONABLE. There is a difference in the immediacy of the stimulus, is there not, and isn't that one of the great difficulties about the ITC that it has a tendency to encourage Government to use it as a kind of a fine-tuning device rather than as a sound part of the overall cash flow picture you are going to have to have in business if you are going to have an up-to-date capital investment policy?

Mr. OKUN. That is a problem but one might say it is an opportunity. Obviously the administration found it attractive to use this 10 percent, 5 percent scaling of the investment tax credit over 2 years in order to get some additional influence.

Representative CONABLE. Yes.

Mr. OKUN. I agree that, whether you look at it as a burden or as benefit, the investment tax credit is susceptible to that kind of variation and fine tuning.

Representative CONABLE. In the long run is there anything that an investment tax credit can do that can't be done by an acceleration of depreciation?

Mr. OKUN. The basic difference is that accelerated depreciation is a permanent loss of revenue to the Treasury but it is a temporary gain to any business firm doing any single investment project. When a business looks at an investment project under accelerated depreciation, it feels it must ultimately pay back the total amount. Calculating the benefits of that investment project, the business firm finds that it is not as much of a benefit as if it had been a nonrepayable credit. Yet from the Treasury's point of view, while it recaptures the money on any single investment project, it would always be running behind so long as investment keeps going up in this country. The only consolation of the Treasury is that the balance sheet on judgment day will show more deferred depreciation that business still owes the Treasury. So the basic effect of ADR compared to investment credit is that ADR tells the business firm "You have to pay it back." That is why every experiment that economists and econometricians have done finds a lot more bang for a buck with the investment credit.

Representative CONABLE. And you get it a lot quicker.

Mr. OKUN. And you get it quicker.

Representative CONABLE. The fact that you can change it quickly seems to be something you value even though it is a pretty confounding thing to businessmen.

Mr. OKUN. It poses a difficult administrative task for those who have to administer the tax laws but it has an obvious enticement to makers of economic policy, both in this administration and its predecessors.

Representative CONABLE. Has it been your conclusion that welfare reform could be implemented next year if the President wished it?

Mr. OKUN. I am no expert on the legislative process. A Democratic Senator on the Senate Finance Committee told me about 4 days before the President's speech that he was very optimistic that welfare reform was going to be enacted.

Representative CONABLE. I take it that was not Senator Long?

Mr. OKUN. You are correct.

Representative CONABLE. Well, I am interested in that because the President has described this as his highest priority item, and now apparently you are blaming him for chucking it over the side here despite the fact that there is——

Mr. OKUN. I am disappointed that he did.

Representative CONABLE. And you feel that if it is enacted that it could be enacted this fall and implemented by July 1, which was the date in our bill on the House side?

Mr. OKUN. Well, if one wants to speculate on legislative strategy and if you will allow me to do that——

Representative CONABLE. Well, I think you have to look at the realities, too.

Mr. OKUN. Well, the President shapes those realities, Mr. Conable.

Representative CONABLE. I wish he were able to do it more.

Mr. OKUN. I am sure you do, and in many cases so do I, particularly in this area.

I wonder what would have happened if he had gone in the other direction and said, "Welfare reform is before the Senate, it is through the House. If it is enacted by the close of this session, I can assure you that my people will be ready to pay checks out within 60 days after enactment. So let's speed up those payments to February 1 instead of July 1. Let's make this an integral part of our recovery program as well as a far-reaching social reform." I wonder whether that might have put the Senate on the spot to respond and to act. I can't make these judgments, but certainly from a social point of view, had that been legislatively feasible, I would have found it much more attractive.

Representative CONABLE. Let me ask you this, sir, do you see any peril in treating the social security payroll tax as just another tax? The average American wage earner looks at this as an investment in his future and has been willing to pay rather exorbitant payroll taxes in relation to the other taxes he pays, and to pay it even though it is a regressive tax. He looks on it as a contribution to his future and not just as another tax. If you start postponing and/or speeding it up without regard to the actuarial situation do you see any possible change in the wage earner's attitude?

Mr. OKUN. Well, if I were more convinced that the timing and magnitude of the increase called for by H.R. 1 was really fully required by the standard of financing that we have applied to the social security system, I might feel that this would be a peril to the system.

It seems to me the system is operating in very substantial surplus at the moment.

Representative CONABLE. Postponement would have a substantial impact on our national deficit however.

Mr. OKUN. No doubt about that. Yes; like any other stimulative measure, it would have that deficit effect overall, and I was suggesting this perhaps as an alternative to——

Representative CONABLE. I am sorry, I didn't mean to get so hung up on this particular topic. I think there are some very constructive things in your statement and I want to come back to question you later.

Chairman PROXMIRE. Mr. Bernstein, you emphasized very heavily the importance of minimum restraints on world trade. You talked about our trade partners in the world. How would you analyze this overall economic package in achieving those goals? The President, No. 1, suggested or proposed or put into effect devaluation of the dollar. No. 2, he imposed this 10-percent surcharge. No. 3, he proposed an investment credit, which, for the first time, only applies to American purchased equipment. No. 4, he is continuing his subsidy for exports, the DISC program, so that we now are building in a set of subsidies which seems to counteract the efforts of all Presidents, Republican and Democratic, over the last 30 or 40 years to try to reduce restraints on American trade, and to try to encourage free world trade.

Mr. BERNSTEIN. Well, I do think that all of these are difficult policies from the point of view of other countries partly because it was done unilaterally by the United States. There are no indications that we discussed it in any way either with the group of Ten or the International Monetary Fund.

Nearly all of them would recognize that the depreciation of the dollar that the President has started is right. They are perfectly willing to see the U.S. balance of payments restored and some of them are so well supplied with reserves they would welcome getting rid of some dollars. Of course, that is in principle. In particular, they are all disturbed about their own industries in world export markets, but they can be made to understand that this is necessary.

How you do it is important.

Now, the investment credit does have a buy American provision but I think it can only be a buy American provision for 1 year. First, it does not apply to import——

Chairman PROXMIRE. Are you sure, are you quite sure of that?

Mr. BERNSTEIN. I will just make sure if you will wait a moment.

Chairman PROXMIRE. Our staff checked it out and told me it was a buy American provision, period.

Mr. BERNSTEIN. It is a buy American preference but only for 1 year, unless the import surcharge lasts longer.

Chairman PROXMIRE. Well, it is my understanding it is buy American as long as the surcharge is in effect.

Mr. BERNSTEIN. That is correct.

Chairman PROXMIRE. I stand corrected and you are quite right.

Mr. BERNSTEIN. And there is a difference, too, it can't be more than 5 percent for imported equipment. You see even if we got rid of the surcharge tomorrow, it would still be a buy American provision for 1 year.

Chairman PROXMIRE. What this does is simply reinforce the surcharge.

Mr. BERNSTEIN. That's right. It reinforces the surcharge. It seems to be especially onerous to three or four countries that compete in very heavy equipment with us. It does not seem to me to be a step forward, but a step backward. I can't really see why we did it at all.

Chairman PROXMIRE. At least one economist has told me that in his view this is not a necessary bargaining weapon. Others agree. Mr. Otto Eckstein argued it was not an essential bargaining weapon.

Let me just indicate the reasoning behind the argument that this would not be essential. One economist writes me as follows:

> * * * the currency decision alone could have provided the same power. The President could simply have served notice that the Treasury and Federal Reserve will not exchange dollars for foreign currency or vice versa. Without the 10 percent import surcharge, other governments would have immediately faced a simple choice: to let their currencies float up to market-determined levels or to be force-fed an endless stream of dollars.
>
> Indeed, with no new import duties, a free yen would have risen about 12 percent against the dollar and the Common Market currencies would have gone up by similar percentages. If other governments wanted the United States to help dampen these movements, the United States could insist that currency rates be discussed along with such American grievance issues as the sharing of NATO defense costs and foreign barriers to U.S. exports.

Without objection, the full text of the letter from which the quoted matter above was taken will appear in the record at this point.

(The letter follows:)

THE UNIVERSITY OF WISCONSIN,
DEPARTMENT OF ECONOMICS,
Madison, Wis., August 27, 1971.

To: Senator William Proxmire and Richard Kaufman.
From: Robert Haveman and Peter Lindert.

We have taken the occasion of the President's newly announced economic program to jot down a few of our reactions to the current outlook and new game plan. Haveman has commented on the domestic aspects of the policy. Lindert, a professor of internatoinal economics, has commented on the international aspects.

1. *The Wage-Price Freeze.*—Clearly some overt interference was necessary (indeed, two years overdue) to interrupt the wage-price spiral. To be sure, a number of options were open—selective jawboning, guidelines based on recorded productivity changes, wage-price controls, or a temporary freeze. While all of these options have advantages and disadvantages, the technique chosen seems to have more than its share of undesirable features.

a. Because the freeze is scheduled or a 90 day period, the *problem of handling bottled up wage-price pressures at the end of the period may be severe.* If the freeze is maintained only for 90 days, the orgy of wage and price increases, bottled up for three months, could well move than nullify whatever wage and price stability is achieved during the freeze. While I judge that the "Nixon package" will dampen inflationary expectations, and hence, reduce some of the pent-up pressures, it is impossible to imagine that the reduction will significantly diminish the pent-up pressures to be released November 12.

This implies that the President will have to come forth with a strong follow-up plan to go into effect after the 90 day period. This was indicated very recently by Commerce Secretary Stans. I judge that this follow-up plan will involve a substantial element of control (though probably *not* a continued freeze) based on productivity change concepts. I would not be surprised if the follow-up policy were similar to the Kennedy-Johnson guidelines. It will also necessitate the establishment of a substantial administrative structure.

This development should be watched very closely. *At a minimum, the Congress should be intimately involved in the planning for this post-freeze policy.* I emphasize this because the major side effect of such a policy and its implementation concerns the relative distribution of national income between wages and profits.

b. *The voluntary nature of the freeze is likely to cause it to be more effective in controlling wages than in controlling prices.* This is so for a number of reasons. *First,* whereas many wages are settled by contracts which are either negotiated or legislated (and, hence, highly visible), most prices are individually set and, hence, far less visible. *Second,* records on past wages are carefully kept by both buyers and sellers, whereas many commodity prices are only recorded by sellers. This makes covert wage rate increases more difficult to effect than price increases. This is reinforced by the fact that business "makes" both wages and prices. They have incentive to hold down the former and incentive to boost the latter. *Third,* labor is far more homogeneous a commodity than are produced goods. For this reason, it is more difficult to accomplish a "price increase" for labor through quality deterioration than it is for produced commodities. For nearly all commodities that one can think of, manufacturers can accomplish a price increase by altering some characteristic(s) of the product. Shoes can be made with thinner soles, TV sets with fewer frills, clothing with lower quality material, and so on. As a result, wages will be frozen much harder than will prices, and as a consequence, profits will grow. *The working man is being told that his wages must stand still while prices creep and profits gallop!* The net effect of this will be seriously regressive.

It is for these reasons that organized labor has understandably opposed the freeze. However, it must be recognized that *all* efforts to directly control wages and prices are likely to have this sort of differential impact. Workers cannot be expected to accept a wage-price freeze unless tax cuts or other changes are specifically tailored to compensate them.

2. *The Effect of the Tax Cuts and Government Spending Decreases on Unemployment.—On balance, the combination of tax cuts and spending decreases is not expansionary.* It is unlikely that any major boost in GNP or reduction in unemployment will be induced by the fiscal package.

a. The proposed reductions in taxes are:

Immediate passage of the increased exemption and standard deduction, now scheduled for January 1972.

Elimination of the 7 percent excise tax on new auto purchases.

An investment tax credit of 10 percent for the first year, changing to 5 percent for the two succeeding years.

While estimates differ, these cuts would entail a revenue loss of from 6–8 billion dollars. Presumably, these cuts will stimulate consumption and investment spending and, hence, lead to a reduction in unemployment.

b. *While the tax cuts will induce some additional spending, there are several reasons to believe that they will not be terribly high-powered:*

The *cut in personal taxes*, while rather large in the aggregate ($2.3 billion) will amount to a very small increase in disposable income for any family. For a taxpayer in the 20 percent tax bracket and with four dependents, the change in exemptions will provide him with less than $50 of increased spendable income. It is doubtful that such a tiny increment will substantially alter his spending plans.

The impact of eliminating the auto excise tax will come from a reduction in the effective price of automobiles. This effect is not likely to be massive. If the price is reduced by the full amount of the tax, new car purchasers will be able to save about $200 per car. *However, I see little reason to expect that the full tax reduction will be passed on.* New auto transactions depend on negotiated reductions in the auto sticker price. Before the Nixon policy, cars were selling at substantial discounts below the sticker price. The effect of the Nixon freeze will be to nullify the price increases on the 1972 models. Most observers feel that this will be reflected in the negotiations between buyers and sellers concerning the size of the discount from the sticker price. The result is likely to be a smaller reduction from the sticker price designed to recoup nullified price increases. *To the extent that this is so, the hoped for effect of the excise tax elimination will not be forthcoming.* (Moreover, as noted earlier, through adjustments in the definition of the commodity, producers can effect a price increase through a reduction in product quality. Automobiles are particularly amenable to such an adjustment through alteration of the "extras" which are to be included in the list price.)

The *investment tax credit* will likely be the most potent of the tax cuts. While its effect cannot be predicted with accuracy, it should lead to an acceleration of investment plans by businesses. Two notes of caution, however: currently the rate of capacity utilization in most industries is very low. For industries in such circumstances it is highly unlikely that the credit will induce major increases in investment spending. Moreover, the Administration's accelerated depreciation rulings are also an investment inducement. Because of their recent promulgation, one might witness a smaller "kick" from the investment tax credit than in their absence.

c. I have described why the tax cuts (taken by themselves) are *not* likely to have major expansionary effects. To cast more doubt of the effect of the package, it must be emphasized that the President proposes to offset revenue losses from the tax cuts by a reduction of nearly $5 billion in government purchases of goods and services. This is to be accomplished by a 5 percent reduction in government spending. This is a high powered reduction. If government spending is indeed so reduced, the reduction in aggregate demand will be immediate and employment will be directly and adversely affected. A dollar of decreased government spending will reduce demand and increase unemployment more than an equivalent reduction in tax revenue of the sort proposed by the President. On balance, I cannot believe that the fiscal package will reduce the level of unemployment.

3. *The Equity Effects of the Fiscal Package.*—Were the demand-unemployment effects of the President's package powerful, one might be prepared to live with some adverse equity effects. The likely ineffectiveness of the fiscal program, however, highlights the serious income distributional effects which it entails.

a. *All of the tax cut measures are biased toward higher income groups:*

The elimination of the *auto excise tax* (to the extent that this does reduce price and increase sales) will benefit two groups primarily—the purchasers of new autos and the stockholders of automobile companies. Both of these groups are concentrated in the higher income classes.

The investment tax credit, in addition to inducing investment spending, directly augments profits after taxes of business firms. This profit augmentation will accrue to the owners and stockholders of business firms, again a high income group. Moreover, the only business firms which will be benefited by the credit will be those firms which are currently making profits. (One has to be paying some corporation income tax in order to take a tax credit.) Smaller and relatively unprofitable businesses will gain no profit augmentation (or inducement to invest) because of the proposal. *Finally, the President's proposal to make the tax credit retroactive to April, 1971 can be viewed only as direct subsidy to profitable businesses and their owners.* No new investment spending will be induced by making the credit retroactive to past actions.

The acceleration of increased exemptions will likewise benefit higher income groups more than middle or lower income classes. This is so because the amount of tax savings provided any taxpayer is directly related to his taxable income level. The higher the level of taxable income, the higher the tax rate, and consequently the larger the amount of tax savings gained from any direct reduction of taxable income. Perhaps most importantly, *neither the increased exemptions nor the increased standard deductions will provide any benefits to people in the poverty class.* To be eligible for tax savings, one must have sufficient income to incur tax liability.

b. As I have already indicated, *the effect of the wage-price freeze will fall more heavily on wage prices than on profits.* This effect is also regressive in that those people whose main source of income is wages are typically of lower income status than those people whose primary income source is profits. Moreover, if organized labor is able to gain some wage freeze exceptions for its members, union members will be aided relative to other workers; the latter group being the unorganized low-wage worker group.

c. *The announced $5 billion decrease in government spending came on the same weekend that Secretary Laird announced that the military budget was going to rise by $3 billion.* If these two effects occur simultaneously, the domestic component of the budget will have to be cut by nearly $8 billion. Because many of the domestic programs provide benefits to primarily low income groups, the combined effect of these two measures will also be seriously regressive.

d. Finally, it should be noted that *the President coupled his fiscal requests with the delay of welfare reform and revenue sharing.* Both of these programs are of high priority because of the benefits which they will provide middle and lower income groups. They should not be so hastily abandoned.

4. *A Proposed Revision of the Nixon Fiscal Package.*—Points 2. and 3. emphasized that the Nixon fiscal proposals are *not* likely to be expansionary and unemployment reducing and *are* inequitable in that they benefit higher income groups at the expense of lower income groups. Reform of the package could be achieved by:

a. *Substituting income tax cuts aimed at lower and middle income people for the proposed acceleration in the personal exemptions and deductions and the elimination of the automobile excise tax.*

middle income groups rather than higher groups.

The effect of this would be to concentrate the tax savings on lower and middle income groups rather than higher groups.

Because lower and middle income groups spend a greater proportion of their disposable income than do higher income groups, this change would have a substantially more expansionary effect than the President's proposals. A good rule is that a $1 tax cut to a lower income person will be more stimulative than a $1 tax cut to a higher income person.

b. *Eliminating the retroactive provision of the proposed investment tax credit.* One could also question the effectiveness of adding the investment tax credit onto the Administration's already effected accelerated depreciation policy. Both of these policies are designed to induce additional investment and subsidize after tax profits. If the investment tax credit were abandoned, one could contemplate a still greater personal income tax reduction targeted at lower income groups.

c. Because the reduction of unemployment is of such high priority, *the proposed cut in government spending should be strongly opposed.* Indeed, one of the most powerful stimulants available would be a welfare reform which supplements the incomes of poor people. Because the savings rate is so low among these groups, a very high proportion of each dollar of benefits would be spent, increasing demand, and creating jobs. Coupling this with increased support for public service employment would be a real Job Development Act.

5. *Some Comments on Interest Rates and the Money Supply.*

a. If the President was able to substantially reduce inflationary expectations by the announcement of his package, one should expect to see interest rates begin to fall. They are likely to remain stable for the next month or so.

b. If interest rates do begin to fall, much of the pressure to expand the money supply (so as to keep interest rates down) will be taken from the Federal Reserve Board. This will enable the Board to pursue a monetary policy which is far less inflation inducing than that pursued in early 1971 (when the money supply expanded at a 10–15 percent rate).

6. *International Aspects.*—None of the domestic measures in the President's new program required adjustments in our international policy. Our military, trade, and payments positions would not be harmed by the freezes or fiscal changes. The President's international moves instead reflect (1) a vague sense of international monetary crisis and (2) a desire to placate certain domestic interests before November of 1972.

The President took two steps. One of them is correct and long overdue. The other is inexcusable and costly.

a. *Cutting the dollar free* from gold and other currencies is a logical step toward repairing the international monetary system. For years "crisis" has been built into the system of fixed exchange rates. This system denied governments the flexibility they needed to adjust smoothly and quickly to changes in the world economy. Fixed dollar exchange rates could be maintained only by severe U.S. belt-tightening or irritating and inequitable exchange controls. *Only when currencies have the chance to seek their own values in free markets will the succession of world monetary panics subside.* The President has recognized that the currency crisis of 1971 (and March, 1968) call for substantial changes, and not just a patching up of old and faulty arrangements.

Letting the dollar find its own international value frees us from some old false concerns regarding the "value of the dollar". The nation will always be rightly concerned about the amount of goods and services the dollar will buy. But the fact that 95¢ of each dollar of our spending and sales is spent on goods produced at home means that the international value of the dollar in terms of other currencies is of secondary importance to the people. Surely the President appreciates this, although his old-style talk of defending our dollar's value against evil international speculators leaves some doubt.

b. Given the correct decision to free the dollar, imposing a *10 percent import surcharge* is hard to justify. Few national goals can be served by this measure.

Given the freezing of the dollar, balance of payments deficits will no longer be a national headache. The market value of the dollar will adjust so that no one is accumulating dollars abroad unless he so desires. *The 10 percent import duty will not help solve the problem of dollar outflows* simply because they are not and will not be a problem given the abandonment of the thankless task of defending unrealistic gold-tied exchange rates.

The import duty has in fact added greatly to the uncertainty that hangs over money markets. Unpredictable daily fluctuations in exchange rates will be more pronounced because of it.

The import duty may serve one function, however. It arms the Administration with a bargaining club to hold over other governments—but the currency decision alone could have provided the same power. The President could simply have served notice that the Treasury and Federal Reserve will not exchange dollars for foreign currency or vice-versa. Without the 10 percent import surcharge, other governments would have immediately faced a simple choice: to let their currencies float up to market-determined levels or be force-fed an endless stream of dollars.

Indeed, with no new import duties, a free yen would have risen about 12 percent against the dollar and the Common Market currencies would have gone up by similar percentages. If other governments wanted the United States to help

dampen these movements, the U.S. could insist that currency rates be discussed *along with* such American grievance issues as the sharing of NATO defense costs and foreign barriers to U.S. exports.

c. A downward drift in the dollar means a competitive advantage for the U.S. exports and producers threatened by import competition. On the average, this price advantage would have amounted to about 5–6 percent if there had been no new import duty. *As it is, with the 10 percent import charge, the dollar will hardly drop at all—and the competitive gain will go completely to import competing Americans, (for example, automobile, TV, and steel manufacturers) with no gain for exporters.*

d. The President apparently chose the 10 percent duty on the theory that the domestic interest that complains loudest needs to be courted most. He chose to provide *visible* assistance to concentrations of import-threatened voters around the country. Those who produce footwear, automobiles, steel, and TV sets, etc., will remember his help as the election approaches. Exporters may be less aware of the help he didn't give them.

e. The main *danger* is that *foreign retaliation* is now completely justified and quite likely. *The U.S. has violated the postwar trade rules that we ourselves set up.* It is unrealistic to think that an import duty is an effective weapon for bargaining for freer trade abroad. Though the Japanese will not retaliate massively with new tariffs on U.S.-made products, nor will they strip away their current barriers or mark up the yen greatly. The Japanese will hardly yield to our pressure at all. The Common Market countries may in fact retaliate. British and Scandinavian entry into the Common Market is creating a bloc powerful enough to counter U.S. threats on most fronts.

f. If, on the other hand, the President had relied on setting the dollar free with *no* import tax, he could have reaped these bargaining advantages:

(1) Less appearance of bullying. Foreign governments can more gracefully give in to "letting the dollar sink" than to aggressive taxation of their exports.

(2) Avoiding the appearance of hypocrisy on trade policy by a country that so recently led the drive to free trade. Without the 10 percent duty, foreign governments would have less precedent for any import duty hikes of their own.

For their part, the Canadians and less developed countries have been shown that the Administration cares so little about their interests that it simply *overlooked* their stake in its panic meeting on an August weekend. They, too, may retaliate.

The import duty, though announced as a flexible temporary bargaining device, will be permanent if no domestic pressure mounts against it in the next few weeks. Once on the books, the surcharge will be well protected by those it protects.

Mr. BERNSTEIN. Let me go into this. In the first place, the import surcharge is itself a factor preventing our achieving the necessary depreciation of the dollar.

Chairman PROXMIRE. It prevents our achieving it.

Mr. BERNSTEIN. That's right.

Chairman PROXMIRE. It stands in the way.

Mr. BERNSTEIN. It stands in the way.

Chairman PROXMIRE. In other words, it is not a helpful instrument, you think it is obstruction?

Mr. BERNSTEIN. It obstructs the market's adjustment to a pattern of exchange rates which we are aiming to achieve in cooperation with other countries. That is because in fact no American importer is going to bid 15 percent more for yen or D-marks in dollars as long as this import surcharge is there. I don't want to say that I know as much as the President or the State Department or the Treasury on the strategy of the import surcharge. I believe, however, that it could have been handled much more diplomatically. It could have been, for example, a contingent surcharge that would come into effect only if a pattern of exchange rates were not agreed on.

Chairman PROXMIRE. What can be done now, now that it has been announced?

Mr. BERNSTEIN. My own feeling is that the wise thing now would be to get a Group of Ten meeting immediately, have them agree that a 12- to 15-percent depreciation of the dollar is desirable. The difficulty would come when each country says how much it would throw into the pot. If we told them we are prepared to devalue the dollar by 7 or 8 percent if they will revalue their currencies, I think we would get a quick agreement. I don't think the British would object to having a modest appreciation of sterling against the dollar because actually it would be a depreciation of sterling on an average of the currencies of all industrial countries. So the thing to do now is to sit down and agree at a Group of Ten meeting and with the International Monetary Fund on the average depreciation, how much is to be achieved through revaluation of other currencies and devaluation of our currency. About six currencies would not need to be changed at all in my pattern. They would simply become appreciated relative to the dollar when we devalue. The other six or seven currencies would be revalued upward. I think that would be feasible, and I would tell all currencies that as soon as an agreement is reached we would get rid of the import surcharge.

Chairman PROXMIRE. Well, now, Mr. Bernstein, if you would follow that tack, what happens to your proposal that by congressional action we should devalue the dollar, is that an alternative that we might have adopted if we had not proceeded as we did or do you think we still should proceed?

Mr. BERNSTEIN. No, I think we have to proceed in the way I gave you. There is no use of the President coming to Congress and asking it to authorize a change in the parity of the dollar until he can assure the Congress that this will go along with a revaluation of certain other currencies and a removal of the import surcharge.

The one thing I am certain of is that we are underestimating the good sense of the American people, and especially of Congress. Such far-reaching changes in the value of the dollar should come only through congressional action. To say that you can get a 12- to 15-percent depreciation of the dollar without congressional action, merely by twisting the arms of other countries, is contrary to the purpose of the Constitution and the intent of the Bretton Woods Agreement Act.

Chairman PROXMIRE. That is very appealing to me. I always have felt we had a constitutional responsibility and duty, and the President is usurping it whenever he changes the value of the dollar. As a matter of fact, we have the money power very clearly, no question about it, spelled out specifically.

Mr. BERNSTEIN. That is correct.

Chairman PROXMIRE. At the same time I think under the circumstances a congressional devaluation of the dollar in terms of increasing the value of gold, I just wonder if that would have been as wise or as effective because the dollar is so universal now, and because, of course, the principal producers of gold, South Africa and the Soviet Union, are not countries that we would necessarily choose to give a windfall to.

Mr. BERNSTEIN. They won't get a windfall. Senator, this is part of the ideology that if we change the price of gold by 7 to 8 percent the beneficiaries will be Russia, South Africa and the speculators. It is

not true at all. The Russians sell no gold at the monetary price. Why should they? They have always been selling it in the free market.

Second, the South Africans have nothing to gain——

Chairman PROXMIRE. But the free market price will rise.

Mr. BERNSTEIN. It won't, it will come down. I will explain.

Chairman PROXMIRE. It will come down if we devalue?

Mr. BERNSTEIN. That's right. The free market price will come down if we devalue. The South Africans do sell some gold to the International Monetary Fund but not because they make more out of it. They sell it to the International Monetary Fund because they want to retain the concept that gold is a money metal which must be bought by monetary authorities. That is the reason they do it. They are paying a little price for the privilige of being able to say gold is still money.

Now, the reason the price of gold will come down in the free market is simple. Speculating in gold can only be rationalized on the assumption that a breakdown of the international monetary system will make all countries say: "All our trouble came from using dollars as reserves. Let's get back to something sensible and old fashioned like gold, and as there are not enough gold reserves we will double the price of gold."

Every time there is a crisis, the free market price of gold rises because the speculators hope the international monetary system will break down. Every time the crisis is resolved, the free market price of gold falls. Before the United States suspended gold convertibility, the free market price rose to $44 an ounce. The minute that other currencies floated upward against the dollar, the dollar depreciated, the price of gold dropped from $44 an ounce to around $40 to $41 right now.

If we had a 7- to 8-percent devaluation of the dollar, that would involve raising the price of gold by $2.80. I think that for a 7.4 percent devaluation, it would be $37.80. It is my opinion that if we devalue the dollar, the free market price of gold would then drop below $40 an ounce, particularly as any such measure would come along with certain changes in the role of gold in the international monetary system.

Chairman PROXMIRE. I would like to ask Mr. Okun to comment on this.

Mr. OKUN. What Mr. Bernstein is saying sounds very plausible to me, particularly with the key fact that he mentioned last about changes in the role of gold. If this is accompanied by a clear indication that central banks aren't going to be adding to their gold and, as I put it, a clear declaration by the United States we have no intention of buying gold any further, and indeed of our willingness to deposit our existing stocks in the IMF and essentially to say that we are out of the gold business, this message would be understood in world markets.

Chairman PROXMIRE. Well, then, a change in the value of the dollar, the formal value of the dollar, with respect to gold is necessary to achieve this.

One of the reasons I am mystified, and I am sure many other laymen must have been mystified, is we are cutting loose from gold now, why worry about that. It seems to me part of the past history.

Mr. BERNSTEIN. Senator, if you are going to have a system of stable exchange rates even with broader margins around fixed parity you have to have some form of common denominator for declaring parity.

The Articles of Agreement of the International Monetary Fund say that each country shall communicate to the International Monetary

Fund the par value of its currency in gold as a common denominator. It uses those terms specifically to make it clear that this does not mean that gold and the currency whose parity is being declared are the same thing.

There is an alternative which is the gold content of the dollar in 1944. To declare the dollar to weigh not 15⅝₁ grains of gold, as President Roosevelt put it into the Executive order, but about 7 percent less than that, would have absolutely no significance for the gold standard. We have no legal obligation anywhere to buy and sell gold. It was an obligation we assumed when we wrote to the International Monetary Fund opting for this choice. There is nothing in our legislation like that.

The Secretary of the Treasury has the power, if he wishes, to buy and sell gold but there is no obligation to do so. I don't think anybody on earth believes we are ever going to buy or sell gold for dollars when we go back to official convertibility. There are other methods of convertibility provided by the Fund agreement. If you don't want gold as a common denominator, I wouldn't care, you could amend the Articles of Agreement to say SDR's.

Chairman PROXMIRE. Why wouldn't the SDR's be the common denominator? That is what we thought we were moving toward, getting away from gold.

Mr. BERNSTEIN. It is a distinction without a difference.

Chairman PROXMIRE. Why not special drawing rights?

Mr. BERNSTEIN. It is not in the Articles of Agreement. It would have to be amended.

Chairman PROXMIRE. Why not do so?

Mr. BERNSTEIN. I don't think it makes any difference. The SDR unit is defined as a dollar in gold. If it would be easier to devalue the dollar in SDR's than in gold, fine.

Chairman PROXMIRE. I have been for it consistently.

Mr. BERNSTEIN. I mean devaluing the dollar is the important consideration. If you want to do it in SDR's, I am willing to do it that way. I have no objection. We could redeclare the parity in SDR's after the Fund agreement is amended. If I were at the Fund, I would accept your suggestion to devalue the dollar in SDR's without hesitation.

Chairman PROXMIRE. I have imposed on Congressman Conable, but let me ask just one last question. If the United States runs further deficits in future years would you recommend another increase in the dollar price of gold?

Mr. BERNSTEIN. The United States isn't going to run more deficits in future years under two conditions. The first is that we establish a proper pattern of exchange rates now. Second, if the United States doesn't have inflation, and by inflation I mean a rise in wholesale prices of manufactured goods, not in the Consumer Price Index.

Chairman PROXMIRE. What was that second assumption?

Mr. BERNSTEIN. Yes, I am about to explain it.

Chairman PROXMIRE. I was going to say that is not a realistic assumption.

Mr. BERNSTEIN. Senator, I just don't agree with you. I know it is easy to give up on all these things but I don't believe that is so. The history of the United States is not one of a country with inflation

except in time of war. From 1957 to 1964 the wholesale prices of industrial goods or manufactured goods in the United States rose by 1 percent for the whole 7 or 8 years. Besides, it is relative inflation—ours relative to that in other countries—that matters. If the United States has relative price stability and then a change in exchange rates were necessary because of what might be called real factors—a change in reciprocal demand for exports and imports—there would be no trouble in getting other countries to agree to a revaluation. What they object to is repeated revaluation of their currencies upward in response to a large and prolonged inflation in this country.

But if we kept our prices reasonably stable, they wouldn't care a bit about appreciating 3 or 4 percent every decade or so.

Now on this business of gold, as I told you, I don't know of anybody in the United States who was more adament than I in the 1930's that the old gold standard had to go. We don't have a gold standard. We haven't had a gold standard since 1933. The definition of a gold standard is a system under which the money supply is directly related to and limited by the quantity of gold reserves. Our money supply has kept growing as the gold reserves went down from $24 billion to $10½ billion. That is not a gold standard. It is true we have used gold as a common denominator.

When we established the two-tier gold market, I had to argue with our officials about what was going to happen. My view then, my view now, is that there is only one way to bring the price of gold down. It won't come down even with a two-tier gold market, even with no Government buying of gold, unless the balance of payments of the United States gets strong. If it gets strong, and especially if there can be no expectation of a large change in the monetary price of gold, the full market price will come down. If at the same time we establish a Reserve Settlement Account, there could never again be gold convertibility of currencies. It would be against the rules of the Reserve Settlement Account. I cannot see how using gold as the common denominator for declaring a new and appropriate par value for the dollar can have any effect at all, except adverse, for the speculators.

Chairman PROXMIRE. Congressman Conable.

Representative CONABLE. Mr. Okun, I note your recommendation that if Congress does not find balance in the President's tax proposals, that it would be better to take the double dip away from business and to give the double dip to the personal income taxpayer. I am wondering if that is related to the rate of savings, and I wonder if you expect the savings rate which has been abnormally high, may come down as a result of the psychological impact of steps designed to reduce inflation?

Mr. OKUN. I would be very optimistic that a program which effectively curbed inflation and reduced uncertainties about inflation would help to restore consumer confidence. I think both inflation and the fear about job security have been deterrent factors to consumer spending in the past couple of years. Both have made people feel that this was not the right time to make long-range commitments and it was a better time to hedge. So I think the overall success of the program does point toward good news on the consumer side.

Mr. McCracken, I believe, used an estimate of $8 billion stimulus from a reduction in consumer saving as a part of the contribution of

this program. I would think if phase 2 is effective that that is quite a reasonable estimate.

Representative CONABLE. And a high rate of savings, of course, also reduces the stimulative impact of the tax cut; does it not?

Mr. OKUN. Yes; to the extent that the saving rate is high, one might conclude that additional income would be proportionately saved to a somewhat greater extent and consumed to a somewhat lesser extent. But even high savings rates still mean a situation where the consumer is putting more than 90 cents of every dollar into consumption markets and saving something like 8.5 percent. Giving the consumer more income will still have some important effect on consumer demand even if there wasn't an improvement in underlying consumer confidence and indeed if there is an improvement this would help to reinforce it to a greater extent.

Representative CONABLE. You present a careful formula for the allowable increases in prices and wages during the post-freeze period when you recommend that all controls be relaxed subject to the roll back feature. I am wondering if you have considered not specifying the amount of an allowable increase? The minute you establish an allowable increase, why shouldn't everybody take it, not only as a ceiling but a floor, particularly if they are concerned about whether the underlying causes of inflation have been dealt with or not? Why shouldn't they do that once you have set a figure? Might there not be some point in leaving indefinite the amount of allowable increase, however valid your formula may be, so that there would be the deterrent also of uncertainty as to whether or not an increase was allowable?

Mr. OKUN. I think under present circumstances you are quite right in saying that the ceiling may become a floor, particularly on wage increases. But when we are talking about a current situation where average compensation over the past year has been 8 percent, I think we could live with 5 percent becoming a floor as well as a ceiling. This would be such a major improvement from where we are now that, although it is imperfect, it looks good to me.

I think the difficulty with any other approach is that the Government has an obligation to give people some sense of what the rules of the game are, and how can that be done except by posting the speed limit.

Representative CONABLE. You could do that by not having a roll back, for instance, but something for which people would have to get advanced approval.

Mr. OKUN. That is true and that is always the attraction of a total control program which says every single decision to change a wage or a price has to have explicit advance approval. But then, Mr. Conable, I think we are talking about the enormous kind of bureaucracy that seems to be the number one negative objective in the President's initial statement. I share that objective fully, and I was trying to offer something which would be consistent with it. I think that a total control system is an acceptance of an impossible job by the Government. When it doesn't work, people don't say the Government took on a job that just couldn't be done. Rather, they say "The bureaucracy loused up again, and the Government never does anything right." There is a whole issue of credibility and faith in Government that goes to the heart of trying to run a total control system. Understanding the need

for the current very tight transition period, I think we can and should come to something a lot freer by mid-November.

It does have a lot of problems to it. I don't think anybody is ever going to produce an ideal system which gives you as much effectiveness in holding down inflation as you would like and as little compulsion and bureaucracy as you would like. I have tried to steer a course in this proposal which minimizes compulsion and bureaucracy and which should enable us to make a major step forward from where we are now.

Representative CONABLE. I sympathize with your intentions there, sir. I think avoiding a bureaucratic explosion is certainly desirable.

Mr. Bernstein, in Mr. Krauss' article in the Washington Post he says:

> Support is growing to amend the IMF so that fundamental disequilibrium need not be proven before an exchange parity can be changed. If small changes, the least disruptive kind, are to be encouraged, then evidence less difficult to establish must be accepted to verify the required case for devaluation or revaluation. Indeed the existence of market pressures which continually force a currency to stay near its floor or ceiling should be sufficient evidence in most instances.

Now, this recommendation that we move away from the par value approach and permit this kind of competitive readjustment makes me wonder. It seems to me that the IMF charter was specifically designed to prevent competitive exchange rate adjustments, and do we really want to get away from that? Why isn't under these circumstances a country likely to be tempted to try to take competitive advantage of another country through this kind of adjustment?

Mr. BERNSTEIN. First, I have not read the Krauss letter but I will after I leave here, but I listened carefully to what you said. It is not correct that a country has to have a deficit to prove that it is in fundamental disequilibrium. The IMF has made a number of interpretations of what fundamental disequilibrium means. For example, a country may have no balance-of-payments deficit at all and still qualify for a change in parity. If it can show that it is keeping its balance of payments from being in deficit only by deflating the economy, it qualifies for a change in parity. The concept that a country must already have experienced a deficit or a surplus to prove fundamental disequilibrium is not really correct. The International Monetary Fund has said that, most recently in connection with inflation. The members of the International Monetary Fund understand that.

Second, the crawling peg could be useful, and if you permit I will put into the record another paper entitled "Flexible Exchange Rates and Balance-of-Payments Adjustment" in which I discuss the crawling peg.

(The paper referred to above follows:)

FLEXIBLE EXCHANGE RATES AND BALANCE-OF-PAYMENTS ADJUSTMENT

(By Edward M. Bernstein)

PRESENT SYSTEM OF FIXED PARITIES

The recent crisis in the foreign exchange markets has raised again the question whether a system of fixed parities is suited to the economic realities of the modern world. The Articles of Agreement of the International Monetary Fund, adopted at Bretton Woods in July 1944, contain the following provisions regarding parities of currencies and the range of exchange rates:

"Article IV, Section 1. The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the U.S. dollar of the weight and fineness in effect on July 1, 1944."

"Article IV, Section 3. The maximum and minimum rates for exchange transactions between the currencies of members . . . shall not differ from parity (i) in the case of spot exchange transactions, by more than one per cent . . ."

"Article IV, Section 5 (b). A change in the par value of a member's currency may be made only on the proposal of the member and only after consultation with the Fund . . . (f) The Fund shall concur in a proposed change . . . if it is satisfied that the change is necessary to correct a fundamental disequilibrium [in the balance of payments]."

In essence, the objective at Bretton Woods was to retain the fixed parity aspect of the gold standard while abandoning the rigidities imposed by the traditional gold standard. Although countries had to establish par values for their currencies in terms of gold, the parities were no longer immutable. The Fund Agreement contemplated a change in the established parity if this was necessary as an alternative to deflation or to imposing controls on current trade and other payments. However, a change in parity could be made only if the payments deficit was expected to endure. To meet temporary deficits, the Fund had large resources of gold and currencies that were to be used, according to Article I (v) "to give confidence to members . . . thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." The requirement of consultation and approval was designed to prevent a change in parity from being excessive and having disruptive effects on the pattern of international payments.

The present system of fixed parities has been criticized as itself a source of instability in a broader sense. Fluctuations in exchange rates are so limited that they can have only a minimal effect in adjusting the balance of payments. The use of reserves and reserve credits on a large scale and over an extended period may cause the imbalance to become embedded in the structure of the economy. When this occurs, there may be no other means of restoring a balanced pattern of international payments except through a change in the parity, a difficult step for large trading countries. The protracted delay in restoring the balance of payments encourages speculative capital movements on such a massive scale as to threaten the international monetary system. According to the critics, this is what happened in the recent exchange crisis. The solution that they envisage is a greater degree of flexibility in exchange rates—either freely fluctuating rates, wider margins from parity, or gradually changing parities. Surpluses and deficits would be permitted to manifest themselves in changes in exchange rates that would facilitate the restoration of a balanced pattern of international payments.

It is no answer to the critics to say that the system of fixed parities is an old tradition, that it has been in operation in its present form for over 20 years, and that for these reasons it should be continued as it is. The system of fixed parities does not derive ultimate validity from its former relationship to the gold standard or its adoption at Bretton Woods. If the present exchange system is to be retained, the justification must be that it contributes to the achievement of a stable and prosperous world economy. If it does not serve that purpose, and particularly if it has become a source of instability and destructive of national and international prosperity, as the critics say, then a new system of exchange rates should be adopted by the members of the Fund.

THE RATIONALE OF FIXED BUT ADJUSTABLE PARITIES

The present system of fixed parities, adjustable with the approval of the Fund, is usually defended as necessary for the growth of world trade and investment. Fluctuating exchange rates would add another element of uncertainty in international payments. The uncertainty could be met through forward exchange transactions. But if exchange rates can fluctuate to a significant extent, and that is the purpose of flexible rates, then the risk of larger fluctuations would raise the cost of forward cover. Even with the present system, the cost of forward cover may rise to 5 per cent or more a year. This is an infrequent occurence with fixed parities: it may be more common with fluctuating exchange rates. In any case, this is not a decisive argument in favor of fixed parities.

The justification for a system of fixed parities is that it contributes to monetary and economic stability in a more fundamental sense. In any free economy, home demand will grow at an uneven rate, with a large increase in a period of expansion and little or no increase in a period of recession. When a country has a rapid increase of home demand, this will encourage an increase of output, but it will also result in an increase of imports of goods and services relative to exports. Thus, in a period of expansion, a system of fixed parities induces an increase of the supply of goods and services relative to home demand, and minimizes the domestic price and cost inflation. There is a dramatic illustration of this aspect of fixed parities in the United States in recent years. From 1964 to 1968, the U.S. balance on goods and services fell by $6 billion because of the inflation of home demand. If there had not been such an enormous increase of imports relative to exports, all of the excessive demand would have had to be absorbed in an even greater rise of domestic prices and costs.

Similarly, when a country with a fixed parity is in a recession because of an inadequate growth of home demand, the effect on production and employment will be moderated by an increase of exports of goods and services relative to imports. This happened on a large scale in Germany between 1965 and 1967. In constant prices, output (GNP) increased by 203 per cent in 1966 and was virtually unchanged in 1967. The export surplus, however, rose sharply in both years. In the boom year 1965, net exports were —0.1 per cent of the gross national product; in 1966, net exports were 1.4 per cent of the gross national product; and in the recession year 1967, net exports were 3.3 per cent of the gross national product. Even without allowance for the multiplier effect, the increase in the export surplus between 1965 and 1967 was a major factor in preventing a serious recession from emerging in Germany.

The stabilizing effect of fixed parities depends on the capacity of the world economy to absorb part of the change in domestic demand when a country has a boom or recession. As no country accounts for more than 15 per cent of world trade, the impact of the change in exports relative to imports in one country can be spread over a vast amount of trade of many other countries. Of course, this is true only when cyclical fluctuations in the large industrial countries are independent, as they have generally been in the postwar period. When the economic conjuncture is coincident in the large industrial countries, changes in the export surplus can help one country only by hurting another. At such a time, coordinated policies of expansion or restraint are necessary. Such policies might have uneven effects on different countries. But the availability of adequate reserves should make it possible to pursue such policies without too much concern about temporary effects on the balance of payments.

It is basic to the system of fixed parities that balance of payments deficits or surpluses should be temporary—that they should ordinarily be the result of cyclical fluctuations out of phase with those of other countries. Under such conditions, a slowdown of a too-rapid expansion in the deficit country or an acceleration of a too-retarded expansion in the surplus country would restore the balance of payments. The adjustment process would be completely in harmony with the needs of domestic policy—to prevent inflation in the deficit country and to avoid recession in the surplus country. Of course, countries may not take the measures necessary for adjusting the balance of payments, and surpluses and deficits may became large and persistent. If this is permitted to happen, the deficit or surplus may become embedded in the structure of the economy.

When the deficit or surplus in the balance of payments cannot be eliminated by acceptable domestic policies designed to restore economic growth with monetary stability, an enduring change has occurred in the relative economic position of the country. It may be due to an inflation that has resulted in an excessive rise in prices and costs in the deficit country. It may be due to a change in reciprocal demand for exports and imports between a surplus country and the rest of the world. In either case, the remedy under the Bretton Woods system is not to deflate the economy of the deficit country or to inflate the economy of the surplus country, but to change the parities of the currencies.

It is at this point, according to the critics, that the system of fixed parities breaks down. The great trading countries, it is said, are not willing to change the parities of their currencies in order to adjust the balance of payments. A devaluation in a deficit country is a confession of persistent error in domestic policy, an unpalatable admission for any Government; and in spite of the blessing of the Fund, it may be regarded as impairing the prestige of the country that resorts

to it. Revaluation, that is, appreciation of the parity by a surplus country, is firmly resisted by exporters who do not wish to surrender the trading advantage they derive from an under-valued currency. Thus, changes in parity are rarely used, and the insistence on retaining over-valued and under-valued currencies generates foreign exchange crises.

Until recently it would have been said that the Fund had succeeded in maintaining a system of fixed parities with agreed changes when necessary. True, there have been only eight changes in parity by large industrial countries since the devaluations of 1949, of which two were the appreciation of the mark and guilder in 1961. This shows, however, that a reasonably well-balanced pattern of international payments (the special case of the United States excepted) was established between 1950 and 1964. The argument that large industrial countries cannot or will not change parities rests on developments since 1964. The delay in devaluing sterling and the unwillingness of Germany to appreciate the mark undoubtedly aggravated the imbalance in international payments. The recent exchange crisis has shown that changes in parity to eliminate a persistent deficit or surplus are not undertaken as readily as contemplated at Bretton Woods.

It is impossible to avoid persistent payments deficits and surpluses if countries do not act promptly to prevent or halt inflation. Fixed parities are best suited for a world that is prepared to combine economic growth with monetary stability. Theoretically, if inflation were at the same pace in all large industrial countries, it would still be possible to have international balance. In practice, in-step inflation is unlikely if for no other reason than the different response that may be expected from the same proportionate excess of aggregate demand. In a world willing to combine economic growth with monetary stability, fixed parities can help in achieving this objective. Even with domestic price and cost stability, properly defined, it would still be necessary to adjust parities when a structural change alters the reciprocal demand for exports and imports.

One of the common arguments in favor of fixed parities is that it will induce countries to follow domestic policies conducive to monetary stability. Unfortunately, recent experience does not bear this out. When a country can finance a persistent deficit because its currency will be held as reserves by other countries (the case of the United States) or because massive reserve credits will be provided by international institutions or by other countries (the case of the United Kingdom), the dampening effect of the balance of payments deficit on domestic prices and costs may encourage a country to delay taking the necessary corrective measures. It is possible that a system of fluctuating exchange rates would be more effective in inducing countries to follow appropriate domestic policies. If inflation manifests itself in a depreciation of the exchange rate, Governments may feel under greater compulsion to halt the inflation than if the effect is seen solely in a fall of reserves which can be disguised or massive reserve debts which are not shown in the reserve position. If Governments are not willing to follow appropriate domestic policies simply to avoid inflation, it is doubtful whether they will be compelled to do this by any system of exchange rates—whether fixed parities or fluctuating rates.

FLUCTUATING EXCHANGE RATES

The policy of fluctuating exchange rates was widely used during the 1930's, but it was regarded as an aberration that had to be tolerated during the great depression rather than as a new instrument for facilitating balance of payments adjustment. In an attempt to maintain the gold standard in the 1930's, countries adopted strong deflationary policies—contracting the money supply at a time of widespread unemployment. The deflationary policies were a complete failure. They intensified the depression and did not save the gold standard. It was only after the United Kingdom and the United States abandoned the gold standard and adopted a policy of expansion that the recovery began. The gold bloc (France, the Netherlands, Belgium and Switzerland) remained on the gold standard until 1936, despite the increasing pressure from the devaluations of other currencies which intensified their unemployment. The best that can be said for the system of fluctuating exchange rates as it actually operated in the 1930's is that competitive depreciation was far better than competitive deflation.

The gold bloc could not continue to maintain fixed gold parities in the face of the large depreciation of the dollar and the pound. When deepening depression compelled France to change the gold parity of the franc in 1936, it was done after

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consultation with the United States and the United Kingdom. At the same time, the three countries declared their agreement on a policy of restoring fixed parities. The Netherlands, Belgium and Switzerland also devalued their currencies and adhered to the Tripartite Declaration. A completely new set of fixed parities emerged in the 1930's quite different from the historic parities under the old gold standard. The outbreak of war prevented the full implementation of the Tripartite Declaration; but its principles of fixed parities, with changes only after international consultation, became the basis of the Bretton Woods system.

The advocates of fluctuating exchange rates argue that policies should be determined with reference to the domestic economy and not with reference to the balance of payments which is a minor sector of the economy. In the United States, for example, exports of goods and services in 1967 comprised 5.8 per cent of gross national production and imports of goods and services comprised 5.2 per cent of gross national expenditure. To determine policy on the basis of the balance of payments is a case of the tail wagging the dog. In fact, of course, policy is not made solely with reference to the balance of payments—either in the United States or in other countries. Moreover, the advocates of fluctuating exchange rates imply that there is a necessary conflict between domestic and international objectives which actually seldom exists. Good policy for the balance of payments is generally, although not always, good policy for the domestic economy.

Persistent balance of payments deficits and surpluses are ordinarily the result of too rapid expansion or inadequate growth. Thus, measures to restrain the economy when there is a payments deficit or to stimulate the economy when there is a payments surplus are consistent with stability and growth of the economy as well as balance in international payments. That is obviously true in the United States and Germany, the major deficit and surplus countries at this time. The Bretton Woods principles are the very opposite of those implied in the criticism that countries must follow policies undesirable for the domestic economy because of the balance of payments. A member of the Fund is not expected to deflate its economy (as distinguished from halting the inflation) in order to restore its balance of payments. On the contrary, it can propose a change in parity and the Fund cannot object merely on the grounds that deflation would be the better alternative. Unfortunately, in practice countries neither deflate nor devalue, but seem inclined to place greater reliance on direct controls affecting trade, other current transactions, and international investment.

On the positive side, the advocates of fluctuating exchange rates argue that with such a policy the exchange market would automatically maintain a balance in a country's international payments. It is implicit in this argument that the real source of trouble is the payments deficit and not the economic conditions which give rise to the deficit. They may be true, in a sense, in the rare case where a deficit is due to a structural change in a country's relative international economic position. It is not at all true in the common case where the balance of payments deficit is due to excessive domestic demand. In a system of fluctuating exchange rates, a country suffering from inflation will find the exchange rate for its currency depreciating in order to prevent an excess of imports over exports of goods and services. As all of the excessive domestic demand will be turned inward, the probability is that in the long run the rise of prices will be greater with fluctuating exchange rates than with fixed parities, unless measures to halt the inflation are taken more promptly because of the obvious depreciation of the currency in the exchange market.

The advocates of fluctuating exchange rates usually assume that the depreciation in the exchange market will be no more than a reflection of relative inflation of prices and costs. This would be so if the behavior of exchange rates had no effect on the speculative movement of short-term funds. In practice, however, the gradual fall of the exchange rate of a currency would stimulate an outflow of funds in anticipation of further depreciation. Under such conditions, with depreciation running ahead of domestic inflation, the depreciation would itself become a cause of intensified inflation. For the exchange rate would not merely achieve a balance in the normal current and capital accounts, but a surplus equal to the outflow of short-term funds. Because of this, the country with inflation would be deprived of some of its output of goods and services, thus intensifying the price effects of excessive domestic demand. Furthermore, the greater depreciation would raise the prices of import and export goods more than

would be justified by domestic demand, and might lead to offsetting wage increases that accelerate the inflation.

In the rest of the world, an inflow of speculative funds from abroad would be equally disruptive for the domestic economy. The speculative inflow would cause an appreciation of the currency in the exchange market and result in a deficit in the balance of payments on current and ordinary capital account. In order to offset the contracting effect of an increased import surplus of goods and services, the monetary authorities would have to expand domestic demand. Furthermore, if the speculative inflow were suddenly halted, because the inflation is brought to an end by the other country, the currency would depreciate, the balance on goods and services would be reversed, and the monetary authorities would have to undertake an offsetting contraction to avoid an excess of domestic demand. The problem would be even more acute if the speculative movement of funds were reversed instead of merely being halted. In brief, management of the domestic economy would not be easier under a system of fluctuating exchange rates if the world economy is being subjected to inflation in a great trading country.

The difficulties that countries now have with movements of short-term funds would probably be greatly intensified under a system of fluctuating rates. The argument frequently made by central bankers that fluctuating exchange rates really mean sinking exchange rates is an expression of the view that they would generate much larger and more haphazard speculative movements of short-term funds. For a country like the United States, with enormous foreign holdings of liquid dollar assets, the danger of large speculative movements of funds (inward as well as outward) in anticipation of fluctuations in the rate of exchange is especially great. With fluctuating exchange rates, the U.S. economy might be subjected to more inflationary and deflationary pressures, arising particularly from speculative capital movements, than is possible under a system of fixed parities.

It may be said that this criticism of fluctuating exchange rates is mainly based on the assumption that they will intensify speculative capital movements. That is so, and it is a reasonable assumption if countries permit inflation to continue under a system of fluctuating exchange rates. Obviously, speculative capital movements would be small, perhaps no more than with fixed rates, if Governments maintain domestic monetary stability. But if Governments are prepared to follow such policies, they can adjust their balance of payments just as well with fixed parities as with fluctuating exchange rates. If countries need fluctuating exchange rates, after a prolonged inflation, in order to test the exchange market before establishing a new parity, they can do that now under the Bretton Woods system. The Fund has been generous in accepting fluctuating rates as an interim measure until inflation is halted and it is clear that a new parity appropriate to the state of the economy can be proposed, approved, and made effective.

WIDER MARGINS ABOVE AND BELOW PARITY

Even if the monetary authorities are not prepared to accept fluctuating exchange rates, they might secure some help in adjusting the balance of payments if greater flexibility were provided through widening the margins of exchange rate movements beyond the 1 per cent from parity established at Bretton Woods. The question of widening the margins for exchange rate fluctuation, while retaining a fixed parity, first arose during the 1920's prior to the restoration of the gold standard by the United Kingdom. Keynes suggested at that time that the spread between the buying and selling price for gold should be widened to ½ per cent to 1 per cent. This would not have added much to the flexibility of exchange rates—in fact, not as much as was later provided at Bretton Woods. As the gold points were about 0.4 per cent above and below parity for dollar-sterling exchange, even a 1 per cent difference in the buying and selling price of gold would have permitted exchange rates to fluctuate by less than 1 per cent from parity.

The same question arose in the United States when the gold standard was restored in January 1934. The Gold Reserve Act of 1934 established a new gold value of the dollar at $35 an ounce. The Treasury was authorized to impose a handling charge of ¼ per cent for buying or selling gold. The effect was to widen the gold export and import points, which set the limits of fluctuation in the exchange rates, by ½ per cent. With the cost of shipping gold between Western Europe and the United States, the gold points were about ¾ per cent above and below parity. This is the margin that most central banks still prefer.

Prior to the Bretton Woods Conference, the possibility of establishing wider margins was discussed once more. In the *Questions and Answers on the International Monetary Fund*, issued by the U.S. Treasury on June 10, 1944, the U.S. technical experts stated their views in these terms:

"It is too much to hope that even a relatively broad range, say 2 per cent [on either side of parity], within which member currencies might be permitted to fluctuate would provide sufficient flexibility for adjusting a country's international balance of payments through a movement in exchange rates. There will, nevertheless, be seasonal or even small cyclical pressures [on the balance of payments] that can be considerably offset by a movement of exchange rates within such a broad range prescribed by the Fund.

"There is to this extent something to be said even on the economic side [as distinguished from the administration of Fund resources] for broadening the range of exchange rates prescribed by the Fund as compared with the old spread between gold points. On the other hand, the permissible variations must not introduce a risk of exchange fluctuations so considerable as to deter short-term financing of international trade or long-term lending for investment. Neither should the permissible fluctuation encourage speculation of a character that would tend to weaken the established structure of exchange rates, or too easily introduce a disrupting influence in the money and exchange markets."

The Bretton Woods Conference decided to establish the limit of exchange rate fluctuations at 1 per cent above and below parity. Nevertheless, it is possible that a wider margin of 2 per cent on either side of parity would facilitate balance of payments adjustments under certain conditions, particularly if the margin were measured with respect to a single currency, such as the dollar. A deficit country (other than the United States) could allow the exchange rate for its currency to fall to 2 per cent below dollar parity; and a surplus country (other than the United States) could allow the exchange rate for its currency to rise to 2 per cent above dollar parity. Thus, the exchange rates between any two currencies, other than the dollar, could actually be 4 per cent different from their cross-rate dollar parities. The exchange rate for the dollar with any currency could never be more than 2 per cent above or below parity, but even this would provide somewhat more leeway for the United States than the present limit of 1 per cent, although not as much as other countries could secure from a wider margin of 2 per cent in the dollar exchange rate of their currencies.

Such a limited degree of exchange flexibility could have little effect on the balance of payments when there is a large and persistent deficit or surplus. When the deficit is moderate and due to ordinary cyclical forces or to minor structural changes in the relative international economic position of a country, a shift in the exchange rate to the lower limit in the deficit country and the upper limit in the surplus country could help to adjust the balance of payments. Some of the substitute devices, such as changes in import charges or in export rebates, which came out of the recent exchange crisis, probably have no more effect on the balance of payments than could be achieved through a movement of exchange rates within a 2 per cent band on either side of dollar parity, particularly as the rise or fall in exchange rates would apply to services as well as to exports and imports. Of course, where the payments deficit is due to inflated home demand, such minor changes in exchange rates could have no effect in improving the balance of payments unless the inflation were halted.

On the capital side, a 2 per cent margin might hold down speculative movements of short-term funds, provided it reduced expectations of a change in parity. Thus, if Currency A falls to the bottom of the range (98 per cent of dollar parity) and Currency B rises to the top of the range (102 per cent of dollar parity), a transfer of funds from Country A to Country B would involve paying a premium of about 4 per cent. If the situation changes, so the Currency A rises to the top of the range (102 per cent of dollar parity) and Currency B falls to the bottom of the range (98 per cent of dollar parity), a reversal of the previous outflow of funds would involve a total cost of about 8 per cent. This is a high potential cost for taking a short position in Currency A and a long position in Currency B unless there is great expectation of a devaluation or an appreciation. In this respect, the wider margin would operate on speculation in much the same way as a high premium or discount on forward exchange. It would discourage speculative capital movements except when anticipations of a change in parity are very strong.

A still wider range, say 5 per cent on either side of parity, might add little real flexibility to the exchange system while undermining confidence in the parity. The 10 per cent maximum shift in exchange rates between two currencies (other than the dollar) is more than is necessary to keep cyclical deficits within reasonable limits. Where the deficit is large and persistent and is due to inflated demand, even a fall in the exchange rate to 5 per cent below dollar parity might not be sufficient to restore the balance of payments. And if the deficit is due to a significant change in the relative international economic position, the exchange rate might fall to the lower limit and stay there indefinitely. This would exhaust the flexibility that the wider range is intended to provide. Furthermore, it would be very difficult for a currency to return to parity, or above it, after it had once fallen to the lower limit of a 5 per cent margin and stayed there for a time. The lower exchange rate would soon become embedded in the structure of the economy and a return to parity would create much the same difficulties that surplus countries seem to have in undertaking a revaluation of their currencies.

Moreover, a wider band than 2 per cent might itself generate excessive fluctuations in exchange rates that could prove disruptive. If exchange rates could move within a 5 per cent band around dollar parity, a fall in the exchange rate by 1 per cent or so below parity would encourage expectations that the fall would continue until the rate reached the lower limit. The risk in selling a currency for which the exchange rate has fallen by 1 per cent would not be very great. The prospect that the exchange rate would fall to 5 per cent below parity, if this is the width of the band, would certainly be much greater than of an equivalent change in parity at present. Unless the authorities intervened, the speculative outflow of funds would almost certainly force the rate down to the limit. Thus, a very wide band would magnify the problem of disruptive capital movements, and either result in exaggerated and unnecessary exchange rate fluctuations, or compel the authorities to intervene to minimize fluctuations in exchange rates.

In short, a wider band of about 2 per cent on either side of parity probably provides about as much flexibility as is consistent with the expectation that exchange rates will actually move within the permitted range. A wider band of 5 per cent might mean more frequent intervention by the monetary authorities on a larger scale to prevent an unnecessary decline in the exchange rate. And where a movement in the exchaneg rate to this extent is necessary, the flexibility will be exhausted with the first serious payments problem and could not be restored thereafter except through a change in parity. It may not be too much to say that when a country does need a 5 per cent fall in the exchange rate, the payments problem is one that could be better met by a depreciation—of course, only after domestic measures are taken to make sure that the new rate will be effective. A 5 per cent band might make it easier for a surplus country to accept a *de facto* appreciation of its currency on the grounds that it is not a change in parity and, in any case, was caused by market forces. That may be the most constructive result that could be expected from a band as wide as 5 per cent on either side of dollar parity.

MOVABLE PARITIES: THE CRAWLING PEG

Because too great flexibility of exchange rates, whether freely fluctuating rates or a very wide band, may stimulate speculative capital movements, an alternative has been proposed in the form of movable parities which may be changed by small but predetermined amounts. Under this proposal, a country would be permitted to adjust its parity at the rate of 1 or 2 per cent a year, with adjustments made monthly, quarterly or semi-annually. Although the change in parity in any one year would be very small, the cumulative changes over a period of years would enable a country to move gradually from a parity that overvalues its currency to one appropriate to its relative international economic position. The basic concept is not new, but it has acquired a much more sophisticated form in recent years.

In his *Tract on Monetary Reform* (1923), Keynes discussed some innovations that could be introduced if the United Kingdom were to return to a gold standard, as it did in 1925. His proposal for a movable peg, combined with wider gold points, was as follows (p. 190):

"The Bank of England should have a buying and a selling price for gold, just as it did before the war, and this price might remain unchanged for consider-

able periods, just as bank-rate does. But it would not be fixed or pegged once and for all, any more than bank-rate is fixed. The Bank's rate for gold would be announced every Thursday morning at the same time as its rate for discounting bills, with a difference between its buying and selling rates corresponding to the pre-war margin [nearly ⅛ of 1 per cent] . . . except that in order to obviate too frequent changes in the rate, the difference might be wider . . . say, ½ to 1 per cent. A willingness on the part of the Bank both to buy and to sell gold at rates fixed for the time being would keep the dollar-sterling exchange steady within corresponding limits, so that the exchange rate would not move with every breath of wind but only when the Bank had come to a considered judgment that a change was required for the sake of the stability of sterling prices."

There are various ways in which a movable parity could be operated. The simplest would be to permit a country to change the parity agreed with the Fund on its own initiative by no more than 1 or 2 per cent a year. The size and frequency of the movement in parity would have to be related to the permitted margin of fluctuation above and below parity in order to avoid discontinuous changes in the exchange rate. Thus, if a 2 per cent change in parity were permitted each year, the preferred range of exchange rates would be at least 1 per cent above and below parity, but could be as much as 2 per cent. This would let the exchange rate move to the bottom of the range before the parity is reduced and start at the top of the range when the new parity is established. Between changes in parity, the exchange rate would be permitted to decline gradually to the bottom of the range if another change in the parity would seem to be indicated. If no further change in the parity were needed, the rate would not move to the floor, but would fluctuate within the permitted range—say, 1 or 2 per cent from parity.

An alternative proposal is to determine the parity by the average rate of exchange in the market over a preceding period—say, the previous 12 months. Thus, if the exchange rate fell to the bottom of the range, 1 percent below parity, and stayed there for a year, the new parity would be 1 per cent below the previous parity. And if the exchange rate then fell again to the bottom of the range, and stayed there, another 1 per cent change of parity could be made after a year. The purpose of basing the change in parity on actual experience in the exchange market is to avoid such action unless it is necessary. Presumably, such a test provides a market justification for a change in parity, although the balance of payments and the reserve position of a country provide a much more realistic test of whether a change in parity is really needed.

The case for a movable parity is that small changes could be made without disrupting the money and exchange markets. The expectation of a 1 or 2 per cent change in parity, spread out over the course of a year, would not induce an outflow of capital if the interest rate differential (a higher rate in the country reducing the parity) were in excess of the maximum change. Furthermore, the premium or discount on forward exchange would be relatively moderate if all that could be expected were a change in parity at the rate of 1 or 2 per cent a year. In short, even assured changes in parities would not disrupt the money and exchange markets if the changes were relatively small. The real question is whether such a system would facilitate adjustment of the balance of payments.

A 1 or 2 per cent change in parity in the course of a year would obviously do little to help a country whose prices and costs are rising by more than this small amount relative to the average of its competitors. And of course, it could not be a substitute for restraint on the economy where the deficit is due to excess domestic demand. The crawling peg seems best suited to offset the balance of payments effect of a creeping cost inflation, without excess demand. It could also be rationalized as a means of offsetting a slowly deteriorating trend in a country's relative international economic position arising from a gradual change in reciprocal demand for exports and imports. In fact, the movable parity is best understood as a case of anticipatory (preventive) devaluation.

The kind of payments problem that undermines the parity—that is, a large and persistent deficit—could not be dealt with through a 1 or 2 percent change in parity each year. Of course, larger changes in parity could be made with the approval of the Fund. The threat of a larger devaluation might still encourage speculative capital movements when the balance of payments becomes very weak. Perhaps the knowledge that a cumulative devaluation of, say, 6 to 8 percent will occur automatically in the next few years would discourage speculators from betting on a large devaluation very soon and would encourage the

monetary authorities to defend the parity *pro tem* by even greater use of reserves and reserve credit than at present. No doubt, if countries follow appropriate domestic policies, some help in balance of payments adjustment could be secured through the additional flexibility provided by a movable parity combined with a somewhat wider range of exchange rate fluctuation—say, 2 percent on either side of parity.

FLEXIBLE EXCHANGE RATES AS AN ADJUSTMENT MECHANISM

All of the proposals for providing greater flexibility in the present system of fixed parities are designed to be a positive help in adjusting the pattern of international payments. The critics argue that the present adjustment mechanism is not working, that it places too much responsibility on the deficit country and that exchange rate flexibility is a substitute for unacceptable domestic policies. Payments deficits have different causes and flexible exchange rates may or may not be helpful in adjusting the balance of payments in any specific case. For convenience, payments deficits may be classified as due to (a) cyclical fluctuations, (b) persistent excess demand, (c) a loss of competitiveness because of a preceding inflation of prices and costs, or (d) structural chnages impairing the relative international economic position of a country. How would flexible exchange rates facilitate adjustment in these cases?

First, a country that has a deficit only when it is in the expansion phase of a business cycle does not really have a payments problem. The test of a payments problem is whether a country has a deficit on an average of good years and bad, qualified to say that the balance of payments should provide a country with an appropriate share of the increase of world monetary reserves. A cyclical payments deficit is properly met by using reserves and reserve credit, a policy that will minimize the long-run price and cost effects of a cyclical expansion. That is the rationale of fixed parities supported by the use of reserves.

Second, a country that has a large and persistent defiit because of excess demand cannot solve its payments problem within the framework of any practical degree of exchange flexibility. A depreciation within a wider band cannot restore the balance of payments if the excess demand is allowed to persists. The best proof of this is the experience of the United Kingdom since the devaluation of sterling by 14 percent. This is much more than any flexibile system of exchange rates could provide, freely fluctuating rates apart, yet it has not succeeded until now in improving the trade balance. In the first three quarters of 1968, after devaluation, U.K. imports increased by over 6 percent in dollar value and by nearly 24 percent in sterling value compared with 1967.

Third, a country may have a non-competitive level of prices and costs even when it no longer has excess demand. If prices and costs are not too far out of line with those of competing countries, a really wide band of exchange rate fluctuation, say 5 percent, might permit adjustment of the balance of payments without a change in parity. Where the loss of competitiveness is more than 5 percent, the wider band would not meet the problem. A movable peg might restore the competitive position after four or five years, but it would require the use of enormous reserves and reserve credit to support an unsuitable parity while the country crawls toward a balanced payments position.

Fourth, a country may have a gradual deterioration in its international economic position relative to that of other large trading countries. The creation of the Common Market, with preferences for trade among members, is a structural change that has affected reciprocal demand between these countries and the rest of the world. The shift in Germany from a rapid rate of growth until 1965 to a more moderate rate of growth in recent years is a structural change which will probably continue as indicated by the demographic data on the future growth of the labor force. Such structural changes are usually gradual and they could be offset by flexible exchange rates or movable parities.

As this brief analysis indicates, flexible exchange rates cannot be a complete substitute for the normal process of adjustment of balance of payments—that is, by restraining expansion in the deficit country and stimulating expansion in the surplus country. Without such domestic measures, the flexibility provided by a wider band or by movable parities would be quickly exhausted. Freely fluctuating rates would, of course, force an elimination of the deficit through depreciation, but it would inevitably intensify the inflation unless appropriate measures were taken to eliminate excess demand. The view that a system of

flexible exchange rates provides an easy and painless method of eliminating imbalance in international payments is without foundation. It may ease the process of adjustment in some cases but it will not be effective unless it is supported by appropriate domestic policies. It may be possible to put off taking corrective measures for a longer time with flexible exchange rates than with fixed parities, but only at the cost of prolonging and perhaps accelerating the inflation. Sooner or later Governments must accept responsibility for establishing monetary stability, for domestic reasons if not for balance of payments reasons.

It may be that we live in a world of perpetual inflation, although one cannot generalize with certainty on the basis of recent experience. In such a world it will be difficult to maintain a system of fixed parities. If this should be true, a more flexible exchange system may be necessary, not because it is inherently better, but because it may be better suited to a world with an inflation bias. If a more flexible exchange system must be introduced, it would be desirable to retain as much of the short-term stabilizing influence of fixed parities as is consistent with some reliance on changes in exchange rates for balance of payments adjustment. A system of gradually moving parities, with a somewhat wider band, perhaps 2 per cent on either side of parity, might be the best alternative to fixed parities with exchange rate fluctuations limited to 1 per cent.

The changes in the international monetary system that would result from limited movable parities and a somewhat wider band of exchange rate fluctuation need not be great. Exchange rates would still be relatively stable over short periods and the monetary authorities would continue to intervene in the exchange market to support their currencies when they have reached the lower limit permitted for the time being. The need for monetary reserves would not be substantially less than at present and an adequate growth of monetary reserves would still be necessary. The dollar would probably have to play an even greater role in the international monetary system. The dollar exchange rate would be the basis for determining the acceptable limits of exchange rate fluctuation and the dollar would be the currency with which the monetary authorities intervene in the exchange market.

It would be impossible for gold to have the same universal relationship to currencies if exchange rates could depart considerably from parities and the parities themselves could be moved frequently. Nevertheless, the gold parity of the dollar could and should remain fixed in a system of flexible exchange rates. The danger of a disruptive preference for gold, however, would probably be even greater than at present. Some form of the Reserve Settlement Account would be necessary, with gold, dollars and Special Drawing Rights used together *pro rata* in reserve transactions between monetary authorities. If the international monetary system is not to have an inflationary bias with flexible exchange rates, it would be necessary to have a strong dollar and a stable and prosperous U.S. economy. Of course, if the United States could achieve this there would be much less reason for changing the present system of fixed parities.

Mr. BERNSTEIN. Now, the crawling peg does seem to me to have a very useful function for a very limited purpose. Suppose we had a world in which there were relative monetary stability within the sense that I have mentioned, because really a system of fixed parities implies that all countries will follow the same price policy which is the stabilization, not of consumer prices, but of wholesale prices of manufactured export goods. In such a system you might have differential increases in the consumer price index depending upon the behavior of services and so on.

We do have on top of this relative price problem, the problem that some countries may find that their export markets are not growing as much as their imports. You have a change in the reciprocal demand relationship of countries. To my mind, instead of trying to adjust that through large periodic changes in parities, a gradual adjustment could be made through a crawling peg.

When you have a country that is having a payments problem because of a demand inflation or cost inflation, you are not going to re-

store the balance of payments with the crawling peg, at least the crawling peg as I understand it. The changes in the competitive position may be too large and a new parity may be unavoidable.

I do not agree with the concept that the position of the exchange rate relative to parity is the best test of whether a change in the crawling peg is necessary. As some of the experts in the past, including Professor Viner, have pointed out, a country can be in complete equilibrium at the lower level of an exchange rate or at the upper level of an exchange rate or anywhere in between the two. As a matter of fact, I wrote a little article once for the Journal of Political Economy which pointed out that in certain countries the exchange rate will usually be at the ceiling and others at the floor. So looking at floors and ceilings of exchange rates doesn't seem to me to be the decisive test whether a change in the crawling peg is necessary. I would look at what is happening to the balance of payments and reserves.

Representative CONABLE. I take it, sir, that you would favor the 10-percent surtax on imports as a temporary measure rather than quantative restrictions on specific items because it is difficult to keep those as temporary measures. I take it also that you look at the 10-percent surtax on imports as primarily a bargaining device, something that represents the big club when we go to to negotiation with the Group of Ten and the others; is that correct?

Mr. BERNSTEIN. Well, I think there are so many points in there that need qualification. I don't like to choose between the Devil and the deep blue sea, I don't like either of them, I wouldn't want the import surcharge or the quantitative restriction.

Representative CONABLE. And whether we impose it you want it to be temporary?

Mr. BERNSTEIN. If there is going to be any such restriction it should be temporary. Second, it may be the administration needed the surcharge for bargaining purposes. When policy gets outside of economics, I am not in a position to second-guess the administration; but I think it would have been better to find out what other countries were prepared to do in the way of setting exchange rates and then make the point that unless we got an adequate depreciation of the dollar we would have to impose a surcharge to put our payments in balance.

Representative CONABLE. Don't you think we will have to continue to exert all the leadership we can in the world markets, or is it reasonable to expect that some other countries may take some initiative with respect to the exchange rates too?

Mr. BERNSTEIN. May I say something off the record?

Representative CONABLE. Yes.

(Discussion off the record.)

Chairman PROXMIRE. Mr. Okun, when you discussed the fiscal situation and stimulus of what our economy needs you suggested a package including, as I take it, no expenditure cuts, pass the Welfare Reform Act as promptly as possible, postpone the social security tax increase, knock out accelerated depreciation, and I am not sure about your position on the investment credit or on the temporary income tax, moving that up. If you knock out the accelerated depreciation do you think the investment credit would be acceptable or not?

Mr. OKUN. I would find it acceptable. I say that now although at the beginning of this year I argued that all the stimulus should be

applied to the consumption sector. I think there are some attractions to the investment credit. It is, in my opinion, a highly stimulative measure and would work promptly.

Chairman PROXMIRE. But you would say as an essential prerequisite you must delete the accelerated depreciation, you shouldn't have both?

Mr. OKUN. That would be my position, yes. On the individual tax, setting ahead the effective date is very attractive and I believe I am on the record on that going back to——

Chairman PROXMIRE. I think you were the one who suggested it originally. In fact this committee incorporated your suggestions in our report. As a matter of fact, what we said was to take the 1973 cut and the 1972 cut and move them into 1971, now is when we need it. It would only be a temporary loss of revenue because we are scheduled to have that kind of reduction anyway in subsequent years.

Now the reason I ask that is I think we have a very, very serious situation of idle capacity and idle manpower, almost 6 percent unemployment, 25 percent of our plant idle, $70 billion shortage of demand according to Mr. Heller and others and, therefore, we do need stimulus. Do you feel this kind of package would give us the stimulus to provide the kind of jobs we need over a period of a couple of years?

Mr. OKUN. I think it is a very good step in that direction. If it is combined with the kind of inflationary slowdown that a good phase two program could accomplish, and a restoration of our net export surplus, it would create the prospect for 1972 to be a very good year of recovery.

Chairman PROXMIRE. Mr. McCracken predicted we would get about a $15 billion increase in GNP out of the President's proposed new economic program. Do you accept that?

Mr. OKUN. I find that a realistic estimate on the assumption that the followthrough on the wage-price and the international front is successful.

Chairman PROXMIRE. He estimated that would mean another 500,000 jobs; do you think that is about right?

Mr. OKUN. That sounds reasonable too. I would be happier with the $24 billion of stimulus that he estimated if no expenditure cutback took place. You will recall the way he reached his $15 billion. He had $24 billion of stimulus through the wage-price and international proposals and the tax reductions offset by $9 billion through the expenditure cuts.

Chairman PROXMIRE. Well, even $24 billion of stimulus if you rely on that in overcoming unemployment including, of course, the psychological effect on savers, the effect of more export and so forth, you still may be short when you recognize that you have one and a half percent growth in the labor force, which is what, a million new people coming in net. In addition you have a 4 percent increase in productivity in a period of recovery, which is another 3 million jobs, perhaps that you need, and then longer hours adding perhaps to that so that you need real growth of around 6 percent just to stay even, just to maintain 6 percent unemployment; is there something wrong with this calculation?

Mr. OKUN. I suspect that that is a high figure of required growth. For one thing, as long as the job market is weak we will probably

get less than our usual addition to the labor force. There is another piece of arithmetic that enters in. The productivity figures that we normally talk about are those that relate to the private economy. On a total GNP basis, it is somewhat lower. I would think anything above 5 percent growth would make a contribution to a reduction of unemployment. Under normal circumstances, we require four and a quarter or four and a half percent growth to stay even. I think your points are well taken that it could be larger than usual in the year ahead precisely because we can look forward to a good productivity catchup and we might get some rebound in the average workweek.

Chairman PROXMIRE. Part of Mr. McCracken's calculation, and I want Mr. Bernstein to comment on this too, was that we were going to get a stimulus from our exports, and he thought, for example, that, as Mr. Okun noted in his statement to calculate the import tax as an increase in revenue and therefore a depressing factor in the economy is just plain wrong. This tax is going to have a stimulating effect on employment.

Mr. OKUN. That credits the import surcharge with benefits that I think are more reasonably credited to the freeing of the dollar. It seems to me that the points Mr. Bernstein made are well taken, that to the extent one's exchange rates are freed the import surcharge may change.

Mr. BERNSTEIN. The sum of the two is not going to be very different.

Chairman PROXMIRE. What I wanted to say Mr. Bernstein, where I wanted to bring you was in the direct effect of getting back to a reasonable trade advantage, $7 or $8 billion, would be a $7 to $8 billion stimulus in the GNP which translates again into what, a half million jobs, close to it, at any rate a substantial increase in the number of jobs which this whole package is supposed to provide. Is it realistic to think we can get back to that, is it really, when we recognize, as you said very well and I think it is so helpful that you said it, if we are going to do this, if we are going to get a $7 or $8 billion favorable balance of trade it means our trading partners are going to have to give up part of their production, lose jobs and they are not going to accept that, that will probably be true all over the world.

Mr. BERNSTEIN. Senator, your statement is absolutely correct and we must not lose sight of it. We cannot get jobs for the United States through increasing our trade balance without reducing jobs in other countries that were the result of their trade surplus. So the surplus countries will have a difficult adjustment to make. I think they will be better off when they make it. A country like Japan has been keeping consumption too low and giving up important domestic investment. They had a trade surplus of $4 billion last year, and this $4 billion deprived the Japanese people of goods they need for consumption and for public and private investment. As I explained to some Japanese visitors, the only way to give the workers more real income without inflation is by giving them the equivalent of the goods Japan is now exporting.

I hope that we will now get the right policies in the surplus countries to maintain a high level of output and employment by substituting domestic demand for their excessive exports. Incidentally, some countries with excess domestic demand and a payments surplus will

have less adjustment to make. They will be pleased to find that less exports also means less inflation.

Chairman PROXMIRE. But I think another element you added to your statement is most helpful which ties in with the position Mr. Okun has just taken. We are going to need a high level of demand worldwide in order to make this work.

Mr. BERNSTEIN. Absolutely.

Chairman PROXMIRE. Therefore it is very important that we have the kind of economic stimulus, fiscal stimulus here so that we can work in an area of negotiations which it is possible for our trading partners to accept.

Mr. BERNSTEIN. Precisely.

Chairman PROXMIRE. If we have a worldwide stagnation or stagflation or whatever you want to call it, continuing for a couple of years the negotiations are going to be almost impossible. It is only if we have a period of increased production, increased demand, increased prosperity that we can work this out; isn't that correct?

Mr. BERNSTEIN. You are right in everything you said.

Chairman PROXMIRE. Therefore a very important part of making the international situation work is to be sure that we take steps in this country, which are so important to the rest of the world, to stimulate our economy and have our economy prosperous.

Mr. BERNSTEIN. That is right and let me add one more thing because it enters into it too. If the United States must increase its trade surplus, it is a mistake to do it all by cutting imports. That is deflationary in the world economy. It is much more helpful if we do less through cutting imports and more through cutting exports——

Chairman PROXMIRE. More through expanding exports.

Mr. BERNSTEIN. Increasing exports, excuse me. I don't think we can have the sole influence on how much of the improvement will be through increased exports. But we ought not to stand in the way of getting the best increase in exports combined with the least decrease in imports. The import surcharge seems to me to be contrary to this philosophy.

Chairman PROXMIRE. Gentlemen, I want to thank you very much. We come to this conclusion at a very appropriate time because Friday—we are not having a session tomorrow, but Friday—we are having hearings on the unemployment situation. We are having Geoffrey Moore, Harold Goldstein, and Robert Nathan who will comment on the President's new economic program.

The committee will reconvene Friday, September 3, in this room at 10 a.m.

(Whereupon, at 12:25 p.m., the committee was adjourned, to reconvene at 10 a.m., Friday, September 3, 1971.)

THE PRESIDENT'S NEW ECONOMIC PROGRAM

FRIDAY, SEPTEMBER 3, 1971

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire and Representative Brown.

Also present: James W. Knowles, director of research; Loughlin F. McHugh, senior economist; Richard F. Kaufman and Courtenay M. Slater, economists; Jerry J. Jasinowski, research economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today's hearings will serve a dual purpose: Continuation of the committee's indepth review of the President's new economic program and an analysis of current employment and unemployment developments. We have the new unemployment figures this morning and we are going to have experts up to testify on the significance of them.

With respect to the first aspect, we shall hear from Robert Nathan, president of Robert Nathan Associates, a firm founded 25 years ago by Mr. Nathan to provide economic policy advice to countries around the world, as well as major industries in the United States.

During World War II, Mr. Nathan, a lawyer as well as an economist, served as chairman of the Planning Committee of the War Production Board. Mr. Nathan was also Deputy Director of the Office of War Mobilization and Reconversion.

Mr. Nathan is also a trustee of the prestigous Committee for Economic Development, that group of forward-looking top business executives which has fostered enlightened business interest in matters involving major national policy issues.

Since Mr. Nathan is also a student of current business development, we shall be interested in his commentary of the current and prospective employment situation.

Following Mr. Nathan we shall also hear from the technicians of the Labor Department which has just released its latest measure of employment and unemployment.

Appearing for the Labor Department will be Mr. Geoffrey Moore, Commissioner of Labor Statistics, and Mr. Harold Goldstein, Assistant Commissioner of Labor Statistics. These gentlemen are well known

to this committee, having advised us on the employment situation ever since the Secretary of Labor discontinued the regular press briefing early this year.[1]

I understand. Mr. Nathan, you have a prepared statement covering the views you are about to present. That will be included in the record at the end of your oral statement and you may proceed in your own fashion.

STATEMENT OF ROBERT R. NATHAN, PRESIDENT, ROBERT R. NATHAN ASSOCIATES, INC., WASHINGTON, D.C.

Mr. NATHAN. Thank you very much, Mr. Chairman.

First, let me express appreciation for the opportunity to appear here today in these important hearings on the critical economic problems of the country.

I should like to read part of my prepared statement and then elaborate many of the points, Mr. Chairman, that are presented therein.

All economists are deeply concerned over the continuing damage inflation has inflicted and the desperate need to slow the pace of price increases quickly and enduringly. There is also an urgent need to bring an early end to the recession and to reduce the levels of unemployment and other idle resources, reflecting an annual rate of some $75 billion losses in output.

At this point, Mr. Chairman, I would refer briefly to the unemployment figures being released this morning. This seasonally adjusted level of unemployment of 6.1 percent, which is fractionally below the peak at the end of 1970, is truly not surprising. We have had a gap now of very, very serious proportions between the levels of potential gross national output and the levels of actual production; and to encounter a gap of some $75 billion, which represents a serious and meaningful loss of production potential, obviously must reflect serious idle resources and, therefore, 6.1 percent unemployment which prevailed in August is not at all a source of surprise.

The question which is posed for all of us and especially for the country, given the condition in which the economy finds itself with tremendously unsatisfied public needs, concerns what we ought to do about this severe waste of resources, hardships to the individuals unemployed and unsatisfied demand in our society.

It is with this in mind that I emphasize rather importantly today the interrelationship between price stabiliaztion on the one hand and economic expansion on the other.

First, let me say with respect to stabilization, that the long overdue administration decision to move off of dead center on these important issues is welcomed. For 2 years there have been many people who have been contending that we cannot continue to afford a do-nothing, let-nature-take-its-course policy, and I do believe that this change in policy or reversal on the part of the administration in and of itself is a welcome step.

However, it is terribly important that the direction and the content of the President's proposals be constructively and critically evalu-

[1] The testimony of Mr. Moore and Mr. Goldstein is not printed in this volume but can be found in "Current Labor Market Developments," hearings before the Joint Economic Committee, April 2, May 7, June 4, July 2, August 6, and September 3, 1971.

ated. The subject matter is so crucial to the national interest, and we desperately need the best possible policies in order to maximize the chances of getting reasonable price stabilization and economic growth again. I believe the economic situation is far too serious to condone petty bickering but the problems are too important and too complex to have a moratorium on public debate.

Regrettably, there are some people who have felt that any serious discussion of these economic measures reflect some sort of sour grapes and is antagonistic to the best interests of the Nation. I disagree with that. The issues are too complicated to be hidden under any kind of a barrel or bushel and ignored on the assumption that any move is a desirable move.

I believe a move is important, and the administration is to be commended on having moved, but it is terribly important that we now seek to evaluate as constructively as we can what is proposed.

As far as this interrelationship between price stabilization and economic expansion is concerned, I believe there is much evidence that we are not now moving vigorously enough to recover from the recession, and today's unemployment figures indicate that it is a serious matter and a serious level of resource idleness which this country is facing.

What distresses me, Mr. Chairman, is the fact that the administration apparently seems to be rather fearful that its stabilization measures will not succeed. Having undertaken the wage-price freeze one would expect logically that the administration would now adopt vigorous programs to accelerate the pace of recovery rather than to continue the cautious recovery policies of the past.

I believe the expansion program, which has been proposed by President Nixon, is inadequate as well as unequitable. It is inadequate because it is very difficult to foresee any substantial number of jobs resulting from the net fiscal impact of the program. Any likely stimulus from the proposed tax reductions will be negated by reduced public spending and less public employment.

Mr. Chairman, if this diagnosis is correct, then in the coming months unemployment will continue at or around the 6 percent level rather than decline substantially as we all would seek and as we hope will be the case.

In interpreting the expansionist or recovery policies of the administration, it is appropriate that we look back briefly to past history. It is clear that the administration resorted to unemployment and recession as the only means of fighting inflation. This tactic was largely unsuccessful as evidenced by what has been going on in the price arena. The release of the wholesale price index yesterday indicates a rate of increase which continues to be truly alarming. Of course, that rise did take place prior to the freeze but it was an alarming pace and what happened to the Consumer Price Index in May and June was also very distressing.

Looking back on the approach to inflation by the administration, one can understand that that high rate of inflation, despite the recession and unemployment, did inhibit the administration from seeking a strong recovery because it was fearful of more inflation. But now that it has imposed the freeze, it seems hardly rational to continue to fear the inflationary impacts of recovery. In other words, if recovery

measures were moderate or timid because of the fear of further inflation, now that positive steps have been taken against inflation in the nature of a freeze, and almost everyone agrees that something will be done after the freeze, it does seem illogical to now hesitate about vigorous recovery measures. I believe that there is an incompatibility or an inconsistency in the administration's program which ought to be subjected to very careful study.

Further, Mr. Chairman, it seems to me that a timid approach to economic recovery will not only delay the return to full employment but it can also make it more difficult to achieve better price performance.

The U.S. economy experienced one of its longest and largest lags in productivity in the period from mid-1968 to mid-1970. Productivity gains had tended to average about 3 percent a year in most of the post-World War II period. Yet in 1968 there was a cessation of growth in productivity and the level in mid-1970 was only fractionally different from what it was in mid-1968.

There are many arguments why that happened. One was the hoarding of labor. Another was that in the inflationary period business was not very conscious of costs. But whatever the reason, there was an unusual and long period of no growth in productivity. As we have measured this lag from mid-1968 to mid-1970, the level of productivity was about 5 percent below the long-term trend line in mid-1970, and we believe that 5 percent can and will be made up, given an increase in production.

By the way, one of the major causes we believe for the recent low rate of productivity has been the fact of low capacity utilization.

When a plant runs at 65 or 70 percent of capacity utilization, it is hard to get the output per man-hour that one gets at 75 or 80 or 85 percent of capacity utilization. When you get up to 95 or 98 percent, very high, then, of course, you may get a reversal and productivity may decline but that is a long way in the future. As far as the present is concerned, we have very substantial idle capacity in this economy and there is very little danger that we are heading toward a high capacity utilization as to limit or lower the amount of productivity.

What does this mean, Mr. Chairman? This means that any substantial improvement in economic activity will bring a higher rate of utilization and that will mean a rapid rise of output per man-hour. If we have a rapid rise in output per man-hour, then labor costs and capital costs per unit of output should go up much less than wage rates or capital cost per input unit of capital.

In other words, rising productivity makes it possible to soak up higher costs in rather considerable degree. It is very, very important for us at this stage to try to get substantial recovery in order to benefit from that productivity dividend which lies immediately ahead of us. As a matter of fact if one looks at the index of output per man-hour one notes that even the modest recovery that we have had to date since the middle of 1970 has brought some rather substantial improvement in output per man-hour, and I think much more is ahead.

Further, Mr. Chairman, it does seem to me that those who are now saying that we had better be cautious and move carefully on recovery

because we are in danger of an overheated economy, are rather silly in their time perspective. When we have a $75 billion gap between the potential gross national product and actual output, it is hardly a time to be concerned about overheating. Now is the time to get that $75 billion of capacity into use. Of course later, as the economy moves toward full employment, we will need to watch and be concerned with fiscal and monetary policies to prevent overheating which could generate further inflation.

As far as the expansionist program is concerned, Mr. Chairman, I think it is terribly important that Congress look at this subject with utmost care. The Congress will have a voice in the fiscal program, and I would urge a much more expansionist orientation in this recovery program than the President has given to it. Also, Mr. Chairman, I would strongly urge a more equitable set of recovery measures.

The existence of so much idle capacity makes it doubtful whether even the bountiful pouring of goodies into the corporation hopper will bring a quick and large spurt in private investment.

As has already been pointed out before this committee, Mr. Chairman, the combination of the accelerated depreciation, plus the proposed investment credit will amount to a very major reduction in corporate taxes and a very substantial increase in the benefits to business. But when business is running at around 70 percent of capacity there are grave doubts as to whether even that level of attraction will have a major impact. By the way, if one looks farther ahead, Mr. Chairman, one would hope that the level of investment which will develop in the recovery period would be sustainable. It would be hoped that we don't encounter a short-term investment boom which will only last a year or two, and this could happen if one emphasizes investment as the major thrust for the recovery program.

That is one aspect of the imbalance in the President's approach which is a subject of considerable concern.

I think the economy would be on a more solid and sounder basis if we placed more emphasis on consumption and ultimate demand as the basis for recovery.

Also, Mr. Chairman, there is a very important problem of equity. With our cities and States in dire need of financial help, with air and water pollution facing us in serious degree, with required massive urban rehabilitation to rebuild and rehabilitate our cities and get rid of the horrible slums which characterize most of our larger cities, with tens of millions of American people living at or below poverty levels in a $1 trillion economy, with billions needed for mass transit to overcome congestion, with more health and recreation facilities and services required, this is hardly the time to chose lower taxes rather than higher expenditures, to restore full employment.

I don't believe, Mr. Chairman, in spending for the sake of spending and I think that public expenditures ought to be handled even more efficiently than private expenditures because we are using funds that belong to the people for the benefit of the people and, therefore, efficiency in public expenditures is absolutely essential. But it seems to me at this stage, to favor private spending over public spending, which is what significant tax cuts would do. raises very serious doubts, and I do believe, Mr. Chairman, that the President's fiscal proposals for the automobile excise tax cuts and huge investment incentives reflect a distorted sense of the priorities of our Nation's needs.

I would hope that we would try to flow more funds into those areas that desperately need added facilities and services.

If I may, Mr. Chairman, digress for a moment and talk about our cities and States, there are many, many cities in this country that are in serious financial trouble, and it isn't all attributable to irresponsible management or fiscal policy. Many, many cities and States projected their revenues on the assumption that we would not have a recession or on the assumption of continued economic growth. When economic growth was halted and actually declined and the recession took hold, these States and localities found they were without the expected means that they had projected.

States and localities cannot quite do what the Federal Government does in terms of fiscal deficits and in terms of resort to the Federal Reserve System for all kinds of credit availabilities. They have limits and constitutional provisions on indebtedness, and they have limits on interest rates and the like. We find that in those localities where the needs are the greatest unemployment has also been greatest, and the lack of fiscal resources has been most serious.

Whether one turns to a general revenue-sharing proposal or categorical aid or a credit against Federal income taxes for State and local income taxes—whichever measure is adopted—it seems clear, Mr. Chairman, that at the present state in our economic situation where expansionist policies are needed, it would be much wiser to arrange to provide financial resources to cities and States than to undertake these tax reductions which the President has included in his proposals. That is why I say that the proposals for expansion are inequitable.

Now, let us turn briefly to inflation. No sane person expects that the battle against inflation will have been won by mid-November when the present freeze is scheduled to come to an end. Nor should the freeze in its present form, presumably a rigid freeze, be extended beyond November. I have doubts whether it would be effective or could work.

Clearly, if we are going to bring inflation under control, the freeze must be followed by organizational and procedural arrangements to slow the pace of increases in prices and in costs.

I agree with those witnesses who emphasize the importance of mobilizing support of various groups and of the general public for anti-inflation measures. But rhetoric alone in calling for support will not suffice. Labor is especially concerned about the principles and the techniques that will underlie ongoing stabilization programs.

If the same degree of equity which characterizes the President's expansionist measures were to be applied in the stabilization field, then labor's alarm is understandable.

If the brunt of the battle against inflation is borne more heavily by labor than by business, labor's cooperation will not be forthcoming. I am not speaking for labor but I think I know workers and I know labor leaders and I do not believe that if they are going to have to carry the brunt more heavily than other groups in our society, we can expect full cooperation from labor.

My thoughts go back to 1965 and 1966 when the price inflation first got underway. Wages did seem to reflect restraint on the part of labor leaders. That restraint did not pay off because labor fell behind, and

the rising costs of living eroded earnings. Real earnings in many cases actually fell, let alone failed to improve as productivity continued to rise. Labor has been running after prices ever since.

I am convinced that the workers across the country are tired of inflation and they want greater price stability, and I believe that most labor leaders feel the same way. The problem seems to be one of assuring that the burdens inevitably inherent in slowing the pace of inflation will be fairly shared. Labor as well as business should be invited to participate actively in shaping the programs and the policies that will come after the 90-day freeze.

In the final analysis, cooperation is going to depend on fairness, and the element of equity is going to depend on Government policies. It cannot be repeated too often that the price of cooperation will be the assurance of fair and equitable treatment.

Obviously if we are going to fight inflation effectively, neither wages nor prices can be allowed to increase without restraint. But we must apply restraints with utmost wisdom as well as firmness.

Mr. Chairman, it is clear, and I think this is reflected in the history of World War II and the Korean war, it is clear that wage increases are more visible and can be more readily controlled than prices. Part of this, I think, stems from what labor claims; namely, you have sort of automatic policemen on wages because the employer serves as a pretty good policeman when there are restraints on wages and you can depend on some help from the employers in enforcement.

Because of this more visible and more readily controllable aspect of wages relative to prices, we need to be sure that those in charge of the stabilization plans do everything possible to prevent profit margins from rising as a direct consequence of more effective wage controls than price controls.

I personally do not believe that an excess profit tax is feasible under present circumstances. We had a rough time with excess profits even in World War II with all of the pressures and patriotism. I just have grave doubts whether that is the way to try to assure equity between wages and prices or between the workers and the employers. If this is not feasible, Mr. Chairman, then that is all the more reason to pursue policies which will clamp down on prices with as much pressure, at least, as is put on wages.

Let me repeat that labor has reason for concern over bearing most of the sacrifices in slowing inflation.

I have friends who have said to me if only wage increases are halted or slowed prices will follow suit. In other words, let's get wages under control and then we don't have to worry about prices and profits. I think this is silly. History hardly bears out this simplistic or overly simplistic generalization.

For 2 years we have had a depressed economy and price competition has not been effective in cutting down inflation. I do not believe that as one studies the last 5 or 6 years one can blame the inflation on labor. Labor didn't start it; labor got caught in the bind of rising prices; its real income was curtailed by rising prices. It ran after these rising prices. Of course, this contributed to the spiral but in braking the spiral one has to be equitable and try to be sure that each specific group bears properly its fair share.

In recent months inflation has been even more serious than in the prerecession days, and we have had a recession attributable to inadequate demand. There are too many administered prices in this economy to rely entirely on price competition in the fight against inflation or to expect that price competition will keep profit margins within reason.

Too many industries have raised prices both before and after wage increases. Too many have sought to widen profit margins in an effort to maintain high aggregate profits when the economy has been depressed. Profits are low, maybe abnormally low, but what economic rule calls for high profits in a recession? I don't ever remember any.

The way to get profits up is to get economic recovery. With economic recovery we can have higher volume and with higher volume we can have better productivity. With better productivity we can have better profit margins, not out of the hides of the workers. We can have large profits in prosperity. We do need direct and strong measures to slow the pace of inflation but these measures must lean heavily against prices if we expect them to be effective in slowing wage gains.

Inequities are already becoming apparent under the freeze. We must not permit serious erosion of the impact of the freeze or we will lose everything, but it would seem wise to begin well pefore the 90 days are over to introduce some flexibility and make some adjustments so as to ease the most severe inequities.

This may sound like backing away from the stabilization program, and I don't mean that at all, Mr. Chairman. We must be tough and firm in our stabilization efforts, but if we are going to be absolutely rigid for 3 months and then suddenly overnight move to a flexible program we may defeat our own purposes because we may be building up so much steam and so much pressure and so much unhappiness and so many distortions in the 90 days that it may be difficult to function effectively at the end of those 90 days.

We are not going to reduce inflation from 5 or 6 percent a year to 0 to 1 percent or maybe even to 2 percent in 3 to 6 months. If we can get the Consumer Price Index consistently below an annual rate of increase of 3 percent by mid-1972, that is going to be quite an achievement, at least it will be in the right direction.

A steady reversal of the inflationary spiral will achieve more over time than a one-shot freeze which is not followed up by effective measures. It is in that respect, I think, Mr. Chairman, that we ought to begin to look ahead toward the flexibility problems we are going to have to face in the post-freeze period and I believe if we introduce some of these adjustments in the interim we may very well be more effective in that post-freeze period.

In essence, what we need now is a combination of a substantial revamping by the Congress of the President's recovery program so as to make it clearly more expansionist and more equitable, and we need an early formulation of an ongoing stabilization program in which all the segments of our society have an opportunity to offer their ideas and to participate, and in which equitable treatment and fair sharing of the burdens are assured.

Let me add, Mr. Chairman, that I believe that the administration, having made a major change in policy and direction, on August 14, should pursue its antiinflation objectives with a range of activities be-

yond what are normally regarded as pure wage and price stabilization efforts.

For instance, we should not refrain from resorting to changes in the strategic stockpile. If a given industry tends to engage in price practices which are considered contrary to the public interests, I see good reason why, if it is consistent with our national security needs, some dispositions from the stockpile might be undertaken or some purchases for the stockpile might be delayed.

I think, Mr. Chairman, that Government purchasing policies ought to be adapted and adjusted to stabilization objectives. If we will recall in the middle of 1970, I believe it was, President Nixon announced a threefold program; namely, the issuing of inflation alerts, the assembling of a productivity management and labor conference, and the adoption of purchasing policies compatible with greater price stabilization. I would hope that the Government purchasing activities would be sufficiently flexible to exercise a bit of elbow grease or muscles to try to bring about greater price stability.

I also believe that it will be necessary to have some degree of sanctions after the 3-month freeze. Whether these sanctions take the form of compulsory delays in the implementation of excessive wage and price increases or whether they might apply to an absolute freeze of a wage or a price for a given period of time in selected industries will depend largely on what the administration thinks it can enforce.

I might say that if the board or any organization that undertakes those stabilization measures adopts guideposts, adopts principles, adopts standards, and these are not adhered to, that board should have authority to allow a certain proportion of the wage or price increases to take place immediately, in order that the total not be kept too rigid.

Mr. Chairman, there are many ways to skin this cat and having started in the direction of doing something about stabilization I would hope, Mr. Chairman, that there will be courage and vision as well as assured equity so that we can be confident of cooperation and participation by all groups in our society.

I thank you, Mr. Chairman.

(The prepared statement of Mr. Nathan follows:)

PREPARED STATEMENT OF ROBERT R. NATHAN

All economists are deeply concerned over the continuing damage inflation has inflicted and the desperate need to slow the pace of price increases quickly and enduringly. There is also an urgent need to bring an early end to the recession and to reduce the levels of unemployment and other idle resources, reflecting an annual rate of some $75 billion losses in output.

The long overdue Administration decision to move off dead center on these important issues is welcome. The direction and content of the President's proposals should be constructively and critically evaluated just because the subject matter is so crucial to the national interest and because the best policies are needed to maximize the chances of success. The economic situation is too serious to condone petty bickering, but the problems are too important and too complex to have a moratorium on public debate. In such a highly charged subject there is no virtue in unanimity.

The inter-relationship between price stabilization and economic expansion particularly needs more attention. Having undertaken the wage-price freeze, one would expect the Administration to adopt vigorous programs to accelerate the pace of recovery rather than continuation of very cautious recovery policies. The expansion program proposed by President Nixon is inadequate as well as inequitable. It is difficult to foresee any substantial number of jobs resulting

from the net fiscal impact of the program. Any likely stimulus from the proposed tax reductions will be negated by reduced public spending and less public employment.

The Administration resorted unsuccessfully to unemployment and recession as the only means of fighting inflation. The continued high rate of inflation has inhibited the Administration from seeking a strong recovery because of the fear of more inflation. But, having imposed the freeze, it is hardly rational to continue to fear the inflationary impacts of recovery. The failure to adopt a more expansionist set of fiscal policies may be attributable to grave doubts concerning the success of the price freeze and subsequent stabilization efforts. A timid approach to economic recovery will not only delay the return to full employment but can also make it more difficult to achieve a better price performance.

The United States economy experienced one of its longest and largest lags in productivity in the period from mid-1968 to mid-1970. Productivity gains which tended to average about 3 percent a year in most of the post-World War II period fell about 5 percent below the trend line by the middle of last year. There are a great many causes for the lag in productivity, but certainly the low ratio of capacity utilization has been an important contributing factor. Even the modest recovery to date has begun to make inroads into that gap. If a substantial recovery can be initiated, there ought to be a rapid rise in output per man-hour with the result that labor costs and capital costs per unit of output should rise substantially less than hourly earnings or the cost per unit of capital. The anti-inflation fight can be helped along by accelerating economic recovery. Also, with the GNP gap at 75 billion dollars it is not the time to put high priority on the danger of early overheating of the economy.

The Congress will have a voice in the fiscal program and I would urge a more expansionist orientation as well as a more equitable set of recovery measures. The existence of so much idle capacity makes it doubtful whether even the bountiful pouring of goodies into the corporation hopper will bring a quick and large spurt in private investment. With our cities and states in dire need of financial help, with air and water pollution, with required massive urban rehabilitation, with tens of millions of Americans living at poverty levels in a trillion dollar economy, with billions needed for mass transit to overcome congestion, with more health and recreation facilities and services required, it is hardly the time to choose lower taxes rather than higher expenditures to restore full exployment. The President's fiscal proposals for automobile excise tax cuts and huge investment incentives reflect a distorted sense of the priorities of our nation's needs.

No sane person expects that the battle against inflation will have been won by mid-November when the present freeze is scheduled to come to an end. Nor should the freeze be extended in its present form beyond mid-November. Clearly, if we are going to bring inflation under control, the freeze must be followed by organizational and procedural arrangements to slow the pace of increases in prices and costs.

I agree with those witnesses who emphasize the importance of mobilizing support of various groups and of the general public for anti-inflation measures. But rhetoric alone will not suffice. Labor is especially concerned about the principles and techniques that will underlie on-going stabilization programs. If the same degree of equity which characterizes the President's expansionist measures were to be applied in the stabilization field then labor's alarm is understandable. If the brunt of the battle against inflation is borne more heavily by labor than by business, labor's cooperation will not be forthcoming. In 1965 and 1966 when price inflation got underway, wage restraints did not pay off. Labor fell behind in its pursuit of rising real income because of the erosion of earnings as the cost of living rose. Labor has continued to race after prices ever since.

I am convinced that workers across this nation are tired of inflation and want greater price stability. I believe most labor leaders feel the same way. The problem is one of assuring that the burdens inevitably inherent in slowing the pace of inflation will be fairly shared. Labor as well as business should be invited to participate actively in shaping the programs and policies that will come after the 90-day freeze. In the final analysis, cooperation will depend on fairness. The element of equity is going to depend on government policies. It cannot be repeated too often that the price of cooperation will be the assurances of fair and equitable treatment.

Obviously, neither wages nor prices can be allowed to increase without restraint if we are to enjoy greater stability. But we must apply restraints with utmost wisdom as well as firmness. It is clear that wage increases are more visible and can be more readily controlled than prices. That is why those in charge of the stabilization plans should do everything possible to prevent profit margins from rising as a consequence of more effective wage than price restraints. I do not believe an excess profits tax is feasible under present circumstances. That is all the more reason to pursue policies which will clamp down on prices with at least as much pressure as on wages.

Let me repeat that labor has reason for concern over bearing most of the sacrifice in slowing inflation. There are some who say that if only wage increases are halted or slowed prices will follow suit. History hardly bears out this simplistic generalization. For about two years we have had a depressed economy and price competition has not been effective in cutting down inflation. In recent months inflation has continued more serious than in the pre-recession days. There are too many administered prices in this economy to rely entirely on price competition in the fight against inflation or to expect that price competition will keep profit margins within reason.

Too many industries have raised prices both before and after wage increases and too many have sought to widen profit margins in an effort to maintain high aggregate profits when the economy has been depressed. Profits are low, maybe abnormally low, but what economic rule calls for high profits in a recession? I believe we need direct and strong measures to slow the pace of inflation but these measures must lean heavily against prices if we expect them to be effective in slowing wage gains.

Inequities are already becoming apparent under the freeze.

We must not permit serious erosion of the impact of the freeze, but it would seem wise to begin well before the 90 days are over to introduce some flexibility and some adjustments so as to ease the most severe inequities. We are not going to reduce inflation from 5 or 6 percent a year to zero or 1 or even 2 percent in three or six months. If we can get the consumer price index consistently below an annual rate of increase of 3 percent by mid-1972 that will be quite an achievement. A steady reversal of the inflationary spiral will achieve more over time than a one shot freeze without further measures that can succeed.

In essence what is needed is a combination of a substantial revamping by the Congress of the President's recovery program so as to make it more expansionist and more equitable, and an early formulation of an on-going stabilization program in which all segments of our society have an opportuntiy to offer their ideas and to participate, and in which equitable treatment and fair sharing of burdens are assured.

Chairman Proxmire. Thank you, Mr. Nathan. I do think your appearance is very well timed in view of the fact that just 2 days ago we had the release of the wholesale price figures which indicated that inflation was far from under control when the President acted on August 14, and just this morning we have these most disturbing unemployment figures which indicate that unemployment is continuing at around 6 percent, much too high, and it once again reflects favorably on your timing and the President's timing.

First, let me ask you about what you think is the effectiveness of this present freeze. Do you think it is working and do you think it is likely to continue to work for the full 90-day period?

Mr. Nathan. Yes, Mr. Chairman, I do think it is working. I am a little bit distressed by the fact that there has been no publicity given to specific violations, but as far as I can see in traveling around the country and in talking with individuals, most businesses and most groups are adhering to the freeze.

Chairman Proxmire. I have been very favorably impressed by what I have read and heard about observance of this. Witnesses who have appeared before the committee have indicated their conviction that this is being abided by. I saw an article in the paper yesterday in

which reporters who checked in this area found so far as they could tell the freeze was effective, so that I think that if nothing else the President has acted at a time inflation was serious, and it has been effective.

Mr. NATHAN. Yes, sir.

Chairman PROXMIRE. Now, you contend that the wage control aspect of this action by the President has its own built-in controls because, of course, the employers and their supervisors and foremen and so forth are going to do all they can to hold down the costs, and the major costs for most firms are wages.

On the price front, however, we have another problem. You say this is unlikely to work on the price front for a longer period.

You also suggested that it would be a mistake just to end the freeze and not have a program ready to act at the time the freeze is over. We had a very specific proposal by Mr. Arthur Okun the day before yesterday in which he suggested that wages be allowed to increase about 5 percent, and that we try to hold price increases overall down to an average of 1 or 2 percent. He did not elaborate but it seems to me that in order to do that it would be necessary to develop a pretty comprehensive and expert group of industry staffs, in effect, to study every major industry in the country to determine what their productivity is and to get at the costs of those industries in order to do that, which is very difficult to do; and then where you have extraordinary productivity to try to roll back prices, where you have average productivity to hold the line, and where you have less than average productivity to permit them to increase. Is that kind of formula in your judgment feasible? We never have done that before. We held the line when you were working in this area in World War II and during the Korean war but to do this much more complicated approach, which I think is logical and desirable, can we do it, do you think?

Mr. NATHAN. Well, frankly, I don't think we can do it quickly. If Art Okun had set this as a, say, 2-year-from-now goal and suggested interim steps, I would have said it was far more feasible, but to do it as a quick objective, while I like the idea of going back to a 1- to 2-percent rate of price increase, which is what we had in the early 1960's, and which now looks like wonderful stabilization and a desirable objective, I find it hard to believe we can go from the kind of increases we have experienced to that in one step.

For instance, let me give one illustration. As of August 14 when the President made his statement, adjustments of rather substantial magnitude were in the process of being made. For instance, new wage contracts were coming up. I think that labor has the right to be concerned about some catchup, but a specific union that is involved in negotiation has an even greater right if a union that has workers of somewhat similar skills has just gotten a big increase. After all, there are equities among workers that one has to take into consideration. If big differences exist between what one union negotiated, say, in July and what another one was seeking in September and was precluded from doing, then those differences are, in my judgment, an inequity that have to be taken into account when one introduces an element of flexibility into the system. I think a 5-percent ceiling would never work as the first step.

Chairman PROXMIRE. It has to be more than that, in your view?

Mr. NATHAN. Pardon me, sir.

Chairman PROXMIRE. It has to be more than 5 percent?

Mr. NATHAN. I think some of the first year settlements of some of the new contracts that are coming up will have to be more than 5 percent from the catchup point of view and from this inter-industry comparison.

Chairman PROXMIRE. Well, could you do this, could you permit that as a rare exception and then try to hold down the others to 5 percent? Mr. Okun pointed out we have the fortunate situation of having settled most of our big union-management disputes, and that the first year's settlement, by and large, is much bigger than subsequent years, and he felt it was a rare, well, relatively rare, situation, not having much overall effect on this inflationary problem to have to have this catchup. He seemed to agree with you in your testimony there would have to be exceptions and he felt it would be practical to make those exceptions without seriously breaching the inflationary problem.

Mr. NATHAN. Well, I think if you make those exceptions you get somewhere. Let me say, Mr. Chairman, the most recent wage contracts have been rather stabilizing in their nature for the second and third years. The settlements that have a big first-year catchup and then are limited to roughly 3 percent on productivity and a cost-of-living escalator are in essence more stabilizing than the settlements we have had before.

Chairman PROXMIRE. Those first-year catchups are, by and large, behind in the big industries—steel, auto?

Mr. NATHAN. Yes; steel, auto, communication workers, railroads--there are still some shop crafts standing by and some operating unions, but by and large if we will make exceptions there, I think we can move toward it.

My own feeling would be to probably vary Mr. Okun's proposal to a full cost-of-living allowance in the first year rather than half. In other words, as we move down the pace of inflation I think that in the first year we probably ought to permit a full cost of living.

Chairman PROXMIRE. You are in a minority there because it is not only Mr. Okun who took that position but Charles Schultze who first suggested it.

Mr. NATHAN. Yes.

Chairman PROXMIRE. And other economic experts have testified it would be reasonable and a good approximation, that it would give you a much quicker phasing out of inflationary pressure, these wage settlements.

Mr. NATHAN. Mr. Chairman, if I may come back to the price and profit picture, if I were more confident that there would not be a widening of profit margins, not due to higher volume which is acceptable, but if there wouldn't be a widening of the profit margin attributable to more effective restraint on wages than prices, I would not be so concerned about it.

Chairman PROXMIRE. Here is where the price aspect of this is so very, very important.

Mr. NATHAN. Yes.

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Chairman PROXMIRE. Do you think it is feasible and practicable, number one, to develop productivity measures? Can this be done and can this be done in a way that would be accepted by industry? Number two, can it be done in a way that would give you an enforcement basis? It is one thing to say you freeze prices; everybody knows what that is and it is relatively easy to spot check it. But it is something else to say this industry has a 10-percent productivity improvement and therefore it must reduce its prices by 5 percent; and then to enforce that, and to perhaps go into court and be able to maintain the 5-percent rollback is correct.

Do you think this is a practical approach? I think if you could do this the psychological effect of a price reduction would be enormously healthful in making this effective.

Mr. NATHAN. Yes, sir; but I have very real problems. I don't think you can do it immediately, Mr. Chairman.

Chairman PROXMIRE. You say immediately?

Mr. NATHAN. 3 months, 6 months, or 9 months.

Chairman PROXMIRE. We have the freeze now; we can't do it immediately. Can't we extend the freeze a little longer and then we can do it? Once you get away from that, it seems to me you have lost this golden opportunity.

Mr. NATHAN. Let me suggest an alternative. It is going to take us some time to develop data on productivity, even for the steel industry, which is a good example because it is still in the process of rather substantial technological changeover to new technologies and new methods and a lot of new mills are in the process of being built. We do know something about productivity in the steel industry, and we do know something about the responsiveness of productivity in the steel industry to levels of capacity use. We know when the steel industry is functioning at 65 percent, we know productivity is horrible; and we know there is a very rapid rise in output per man-hour as you move up in that scale to 80, 85, or 90 perecnt of capacity utilization.

It is an industry that has been studied and studied. Yet in my judgment, it is going to take some time to develop data with precision. That is why I would say if we were to move from the total freeze to a full cost-of-living adjustments in this interim, we can have a better feel of what is happening to profits. We can have a better feel then of what possible inroads on labor costs and real wages are being made, and I think that labor probably would be more inclined to be cooperative. If they got the full cost-of-living adjustment, let's say, for 6 months or a year while this information is being developed and a tighter set of standards or guideposts are being formulated, I think you have a better chance to get labor cooperation and then maybe move toward this further measure.

There is some justification, of course, for a little less than cost-of-living adjustment especially if your wage rates are rising more rapidly in certain sectors than in others because of abnormal low levels of wages. For instance, in the 1960's one of the reasons why the cost of living rose was because wage rates were rising more rapidly in the servive industries than they were rising in general industry, and this was justified even if productivity didn't rise that much, because these people were seriously underpaid.

So I would suggest, Mr. Chairman, that perhaps a transitional period in which maybe the wage increases had a limit of 6 percent instead of 5, where you let the full cost-of-living elements be translated would be more logical than to try to go right from the freeze to a half of the cost-of-living adjustment.

Chairman PROXMIRE. My time is up. Congressman Brown.

Representative BROWN. Mr. Nathan, as the last of the six second-guessers, I am interested in your comments about the 1- to 2-percent price increase in the early 1960's as a desirable objective. Now that is where you think we ought to level off here when we get through these adjustments; is that correct?

Mr. NATHAN. Well, sir; I would like to see it even lower if we could go for a 1-percent increase that would be even better. As a matter of fact, it averaged from 1960 to 1964 1.25 percent, and then it jumped in 1965 and in 1966 went even higher.

Representative BROWN. Will you tell me what the unemployment rate was in the years 1960 to 1964?

Mr. NATHAN. We started at around 7 percent with the 1960 recession and then the unemployment rate dropped slowly in 1962 and 1963 and 1964. In 1964 it was down somewhere above 5 percent and then in 19——

Representative BROWN. Did it ever get below 6 percent before 1964?

Mr. NATHAN. No; I think it stayed around 6 percent.

Representative BROWN. How long do you think unemployment would have to stay at 6 percent to get down to a 1- or 2-percent price increase? Are the two things tied together and what is the tradeoff?

Mr. NATHAN. Well, I think there is an interrelationship but I don't think there is a quantitative tradeoff. I think when unemployment is at 6 percent with the degree of inflation we have had, my guess is that if we were to resort to unemployment and idle capacity as a means to getting down to a 1-percent price increase we would have to go to at least 10- to 12-percent unemployment. In other words, I think you have a completely different situation now than you had in the early 1960's when you had rather modest price increases in a recession and when then you had growth in the economy steady but not as rapid as I think was desirable in the economy steady but not as rapid as I think was desirable, and you were able to hold that price level; but now you start at a much different situation.

Representative BROWN. You had a couple of bad years immediately before that; you had 1958.

Mr. NATHAN. That is correct.

Representative BROWN. And to an extent you had something in 1960. Now this is the—after a wartime period—first period of adjustment we have had, isn't that correct?

Mr. NATHAN. After which wartime period, since World War II or since the Korean war?

Representative BROWN. I am talking about the war we're in now.

Mr. NATHAN. Well, this adjustment started well before a curtailment of military expenditures—you see the growth in our GNP stopped late in 1968. The gross national product fell below our productivity potential, actually back in 1968. It was in 1966 and 1967 when the gross national product exceeded potential. We were really

overheated, but it was in the middle of 1968 when the gross national product in real terms practically stopped growing.

Representative BROWN. This all as a result of inflation; is that correct?

Mr. NATHAN. Well, that is true, prices accounted for whatever rise in dollar income we had. But we had no reconversion from war in 1968 or 1969.

Representative BROWN. Now, the reconversion didn't begin until 1969?

Mr. NATHAN. That is correct.

Representative BROWN. You started bringing men home from Vietnam and releasing people from the services; isn't that correct?

Mr. NATHAN. Yes; very small one in 1969.

Representative BROWN. And cutting back the expenditures in that war, cutting back the total defense expenditures in 1969; isn't that correct?

Mr. NATHAN. Well, total defense expenditures leveled off in 1969 but we really didn't start the demobilization until 1970. I personally, Mr. Congressman, do not regard the recession here as mainly a reconversion recession.

Representative BROWN. But nevertheless there is a problem here of achieving this 1 or 2 percent?

Mr. NATHAN. Yes, sir.

Representative BROWN. And also achieving the low rate of unemployment; isn't that correct?

Mr. NATHAN. Yes, sir. There is a problem.

Representative BROWN. Perhaps a 1 or 2 percent aim may be a little low and perhaps the 6 percent unemployment figures that went with it back in the 1960's may be a little high?

Mr. NATHAN. I think so. That is why I say in my own statement, Mr. Congressman, if we can get down below 3 percent and not a fluke, not a temporary phenomenon, but a persistent trend by the middle of 1972 I think this would be quite a remarkable achievement.

Representative BROWN. May I change the subject to a discussion about the profit levels? You said that you didn't think an excess profits tax would be appropriate at this time. There are very few excess profits to tax, aren't there?

Mr. NATHAN. That is quite true, but we hope that with an improvement in economic activity from a vigorous expansion program there will be much higher profits.

Representative BROWN. The current situation is that the profit level is lower than the average?

Mr. NATHAN. That is correct, sir.

Representative BROWN. Can you relate that to the savings level of the individual consumer?

Mr. NATHAN. The savings ratio is much higher than the average.

Representative BROWN. When we look at those two figures, the profits of industry and the savings of the individual consumer, are you able to extrapolate with reference to what wage increases or price increases have been part of the inflationary picture? It appears to me perhaps when the individual consumer has greater savings than he has had before, that his wage increase may be keeping up with his consumption demands, but when the profit levels are much lower than

they have been in the past that perhaps the industry's ability to reinvest is not keeping up with what would be desirable in an expanding economy and, therefore, things like the investment tax credit and the excise tax removal have some relationship, not specifically the excise tax removal, but the surcharge on the foreign goods coming into this country might have some bearing on the desirablity or the ability of industry to make profits and invest.

Mr. NATHAN. I think these two subjects have a relationship. Let me say in my judgment the high rate of savings by individuals in this country now is far more a consequence of unemployment and the fear of insecurity by consumers than it is the fact that their wages are adequate to provide them with what they want to buy.

Representative BROWN. Let's sort of differentiate here between what they want to buy and perhaps what will be normal purchases on a sustained basis. Perhaps they cut out luxury purchases; is that what you are saying?

Mr. NATHAN. Yes, sir; because of insecurity.

Representative BROWN. And industry has cut out its—now, you say because uncertainty; it isn't because the money isn't there but it is because of uncertainty?

Mr. NATHAN. Uncertainty about their jobs?

Representative BROWN. Yes; but the money is there because the savings rate is higher.

Mr. NATHAN. Certainly there could be more money spent.

Representative BROWN. Now, with reference to industry, let's look at the picture in industry for a moment. If investment has been reduced and the profits are lower, is that because of confidence or is that because the money isn't there?

Mr. NATHAN. No; I think it is because of inadequate demand. You can call it confidence if you want.

Representative BROWN. What about the money? What about the profits? In other words, the money, the prospect of profit, the money from which you hope by earning to make an additional investment.

Mr. NATHAN. Certainly the prospect for profits with the continued prospects for recession are not conducive to investing.

Representative BROWN. I just want to push on for a minute to make the point here if I can or to let you help me make the point and that is the stimulation of the consumer with a larger tax reduction isn't really quite as vital as it is to stimulate the industrial investor with an investment tax credit?

Mr. NATHAN. Except that if there is a lot of idle capacity then you have to have a tremendous incentive to build new plants. If you have a factory that is only working at 70 percent of capacity, and you don't see the likelihood of more demand from the customers so that you can use that plant more fully, it is going to take a tremendous incentive for you to put up a new plant or to expand your plant.

Representative BROWN. Here is where we get to the excise tax, right? The removal of the excise tax may be just the incentive?

Mr. NATHAN. The excise tax may just——

Representative BROWN. Senator Proxmire said something about the psychological effect of the price reduction. The psychological effect of the price reduction certainly would come from that removal of the excise tax in automobiles; would it not?

Mr. NATHAN. There is certainly no doubt in my mind if the automobile excise tax is lifted you are going to have an increased demand for cars because of a lower price.

Representative BROWN. Apparently a lot of car sellers are doing that by saying, "Come buy your car now because Congress is going to take off the excise tax."

Mr. NATHAN. There ought clearly to be a stimulation of demand, but with pollution——

Representative BROWN. It does have impact on the economy; does it not?

Mr. NATHAN. No question about it.

Representative BROWN. Automobiles have to have tires and auto parts and steel and glass of other industries?

Mr. NATHAN. No doubt about it.

Representative BROWN. So you don't doubt the ripple economic effect throughout the whole economy; do you?

Mr. NATHAN. No; but if you cut $2.5 billion in other items and you reduce expenditures that would have a rippling effect——

Representative BROWN. You wouldn't suggest expenditures here—what would that do to the Government's deficit in view of the deficit we have this year? You have kept the taxes the same but you have got lower——

Mr. NATHAN. Revenue affects deficits, as well as expenditures.

Representative BROWN. For the Federal Government. You are suggesting even further Federal expenditures and does that have any bearing on inflation?

Mr. NATHAN. Well, it depends on whether you have idle capacity or not. The reason why we have these huge deficits, and goodness knows the President must be one of the most unhappy persons in all the world because he always has hated deficits, but the reason why he has these huge deficits is not spending. The reason why they have huge deficits in revenue. You have a recession; you have reduced profits; you have reduced income and you have reduced revenues. As a matter of fact, the President himself has stated as his goal an expenditure level which would result in a balanced budget at full employment. The reason why we don't have a balanced budget now is because our revenues are down due to the recession.

Representative BROWN. In 1960 or when was it, 1961, I guess, 1961, 1962, did you recommend a reduction in taxes?

Mr. NATHAN. I recommended part tax reduction and part expenditure increase.

Representative BROWN. That is when taxes were reduced?

Mr. NATHAN. In 1964 they were reduced $13 billion. I thought that was a mistake then, sir.

Representative BROWN. I mean in the early Kennedy years, wasn't there a tax reduction?

Mr. NATHAN. Not nearly the reduction you had in 1964. We had a modest reduction in 1961 but nothing like 1964.

Representative BROWN. With the intention of stimulating the economy?

Mr. NATHAN. That is correct.

Representative BROWN. What was your recommendation in 1961?

Mr. NATHAN. I remember talking to President Kennedy within 3 months after he became President. I was not in the Government and I urged increased expenditures along with tax cuts.

You see, Mr. Congressman, let me say this: It is my conviction if we could get the economy stimulated by increased public expenditure of States and localities and for welfare, whatever you pick, we are going to have less of a deficit than if you don't try to get the economy going.

Representative BROWN. Revenue sharing?

Mr. NATHAN. That is one way.

Chairman PROXMIRE. Mr. Nathan, you, I think, left me between saying we have an effective freeze, on the one hand, and saying you would approve Mr. Okun's proposal, but it would take some time to put into effect. You say there should be a period of maybe a year, maybe 2 years, in which you work out these productivity studies and in which you get into a position where you can secure the cooperation of industry and of labor for this new approach to price stability.

What do you do in that period—what kind of system of holding down prices and of having a fair wage policy do you apply?

Mr. NATHAN. Well, I would strongly urge, Mr. Chairman, that in the interim period starting on November 12, 13, or 14, however, one computes the time element, I would certainly have something in the nature of a stabilization board. I think that guideposts, standards, guidelines, whatever you want to call it, ought to be established. I think that there ought to be very severe limits on any increases, subject to evidences of inequities and hardships, and I think that during that period probably, Mr. Chairman, if you can move toward or a little below a 3-percent rate of price increase as your first goal, I think that would be highly desirable.

Chairman PROXMIRE. Then on the wage front would you try to aim at an average 5 percent increase with the exceptions that you pointed to where you have a union which is in the process of negotiation or a union that has already agreed to a contract which would provide for maybe a 6-percent or 7-percent increase; you would permit that?

Mr. NATHAN. Yes; I would.

Chairman PROXMIRE. But you would aim during the period at holding down wages to a 5-percent increase and would use Presidential jawboning and the recommendations of review boards, publicity, or would you rely also on legal sanctions? Do you think Congress ought to pass a law, providing the President has the power, to mandate a limitation on wage payments and mandate a limitation on prices during this period?

Mr. NATHAN. Yes; I would give them sanctions.

Chairman PROXMIRE. You would give the President sanctions?

Mr. NATHAN. Yes; allow him to set the limit and also to limit prices or costs absolutely or in part, or to put off increases for a given period of time.

Chairman PROXMIRE. That would be during this transition period?

Mr. NATHAN. That is right. But whether to start with 5 or 6 percent, Mr. Chairman, I think one has to recognize this is a process of what one might call despiraling outward rather than inward. What we have had is labor sees the cost of living going up, and it says, "We

have to catch up," and then business raises prices in anticipation of wages, then it raises prices again after the wage rise, and then labor goes back again. What we need now is the exact opposite process and it has to be an interrelationship; and I would strongly urge that in this period we try to be firm but flexible.

For instance, I believe that past contractual obligations ought to be permitted to be carried out, namely productivity improvements and the escalator provisions.

But I think where the slowdown has to be achieved is in the first year adjustments, the new contracts, the new arrangements, the new price setting. That is why I think we have to be firm and somewhat heavy-handed but we have to be even-handed, too, between labor and management. It is on the new contracts where I think the firmness is most important. The big productivity lag offers much help in this process.

Chairman PROXMIRE. All right. Now, on the unemployment front, you are testifying on a morning when the unemployment has been disclosed at 6.1 percent; it has been stagnant at that level for some time now more or less for about 6 or 8 months?

Mr. NATHAN. Ten months, actually.

Chairman PROXMIRE. I guess 10 months; I think that is correct. What do you specifically propose to really get moving on this, recognizing the very valid point I think Congressman Brown has raised that the President has pretty much of a full employment balance now, if we increase expenditures that we are going to have a full employment deficit, and that deficit may have to be rather large if we are going to get unemployment down fairly quickly. I am delighted that you made the point no other witness has made with the same force, that this gives the President an opportunity to stimulate without inflationary impact because the freeze does compel that.

Mr. NATHAN. That is right.

Chairman PROXMIRE. And he should take advantage of it to stimulate the economy now and work unemployment down. How do you do it without subsequent inflationary pressure?

Mr. NATHAN. Well, Mr. Chairman, I think that while, in general, I agree with the full employment balanced budget—in other words move toward a balance at full employment—I think at a time when the economy is on dead center and has not been moving significantly one may have to shift from that objective to some degree to a full employment deficit temporarily.

Now, you said, Mr. Chairman, that may have to be a very substantial shift. I don't think so. I personally believe if we were to move from a balanced budget at full employment to an expenditure level which might generate a full employment deficit of maybe $6 billion or $8 billion, I think that would be adequate to get the economy moving.

I believe, then, Congressman Brown, that this would give encouragement to business and there would be more expansion; and if you begin to get more investment and if we begin to get a larger export balance due to the floating of the dollar and the shift from foreign goods to U.S. goods, I think you can start accelerative processes.

If you find as you begin to get more ultimate demand from the consumers that you still need some impetus from private investment then I would favor substituting the investment credit for the accelerated depreciation. I wouldn't have both of them under any circumstances.

Chairman PROXMIRE. You would substitute the investment credit for the accelerated depreciation?

Mr. NATHAN. Yes.

Chairman PROXMIRE. Other economists, including some very able people, and you, I am sure, highly respect, Mr. Schultze, Mr. Heller, and Mr. Okun and so forth, have argued that we ought to give considerable emphasis to stimulating the economy through tax reductions that are temporary. We ought to speed up the 1972 and 1973 into 1971—that is those cuts that are scheduled to take effect. We ought to postpone the big increase in social security taxes scheduled to take effect on January 1st. How would you feel about that? That does stimulate the private sector but it is temporary; it doesn't erode your long term revenue base; and they argue that if we do erode our basic long term Federal revenue that we are going to be in serious difficulties come 1973 and 1974, with the kind of programs we need on a long term basis to cope with the welfare problem and so forth.

Mr. NATHAN. I agree a hundred percent with that. We should not have a tax reduction, but I would bring forward the increase in standard deduction and the increase in personal exemptions.

Chairman PROXMIRE. You are in favor of that?

Mr. NATHAN. I would favor making retroactive to July 1 of 1971 that increase in the standard deduction and increase in personal exemption. I would certainly delay the social security tax increase for maybe 3 or 6 or 9 months to see how the economy is moving; but I share with them absolutely the concern over the long term tax base.

As I travel around this country and around the world, I am deeply distressed to see what is happening to our cities and see what is happening to our water and see what is happening to our air and see what is happening to many, many basic aspects of American life. To say we ought to have tax cuts is wrong. I think we are just going to have more swimming pools and more poverty, and while I happen to have a swimming pool and I enjoy it very much, I don't think it ought to be given priority over taking care of the poverty program and expanding unemployment compensation benefits, and providing more recreational, health facilities, and urban development—those ought to be given priority.

Chairman PROXMIRE. But these same economists recommended to us that the expenditure proposals we make should also be temporary so we will be in a position to make the permanent decisions without being handicapped by having made commitments in the public works area and other areas to provide immediate employment that might follow along. In other words, they are suggesting things like providing payments to the localities, to make up the difference between the short fall they suffer in a recession period with low employment and high unemployment, that kind of thing which we can phase out as time goes on.

Mr. NATHAN. Yes, I would strongly favor providing States and localities with supplementary moneys.

Whether we can phase them out or not is another question, Mr. Chairman, because as I see the longer run problem, unless something is done to build the fiscal capability of States and localities we may be in for very serious continuing problems of financing public services

which, in my judgment, might lead to Federal assumption of many of these responsibilities which ought to stay at the State and local level.

Chairman PROXMIRE. How do you meet the issue that Mr. McCracken made to this committee when he indicated if we do too much too suddenly it might be counterproductive, that the heart of the recovery is in persuading the consumer to spend more than the 91.9 percent of his income that he is spending now. He is saving 8.1 percent, as you know, and if we can persuade him to expend more, there is where the administration says the solid stimulus will come from. If he is concerned about inflationary policies of the Government, he may not be willing to expend that.

Mr. McCracken argued that we would get a $15 billion improvement in GNP from the President's recovery program; he argued we would get 500,000 new jobs. Can you come up with a program that you think would be more effective in reducing unemployment without destabilizing the economy, too?

Mr. NATHAN. First of all, I do not believe that any expansionist measure today within reason is destabilizing. We have a $75 billion idle capacity utilization and we have 6.1 percent of the labor force idle and admittedly other hundreds of thousands not seeking jobs because they are not confident they can find those jobs. I really think we must do more than merely encourage people to spend. We have to have a program in which people have confidence with respect to results; namely, that there are going to be more job opportunities. Once we provide more job opportunities there will be more consumer spending.

Paul McCracken talked about a half million jobs as a result of the stabilization effort. He may be absolutely right. But what we need to do now is to provide at least 4 million jobs in the next year. You have demobilization of veterans, not large numbers but demobilization of veterans; you have 2 million more than normal unemployed now who ought not to be unemployed, above the normal level, and you have another large increment coming up in the labor force, so that half a million is highly welcome but what I think, Mr. Chairman, is needed, and that is why I called for a much more expansionist fiscal policy, is a set of policies which will convince the people that there will be more jobs. Once they are convinced then I think there will be more spending and with more spending we will move toward fuller employment.

Chairman PROXMIRE. Part of it is growth in the labor force; part of it is the very issue you hit so hard—productivity; as we increase productivity what does that mean but the same number of people can do more work?

Mr. NATHAN. That is right.

Chairman PROXMIRE. If you increase productivity by 4 percent it is the equivalent of about 2.5 million jobs; if it is 1 percent it is a million jobs.

Mr. NATHAN. That is correct.

Chairman PROXMIRE. You put that together and you are going to need a whale of a lot of jobs to just stay even, not to increase employment.

One other point, Mr. McCracken said we are going to get stimulus, substantial stimulus, from the President's international program by encouraging exports, by discouraging imports, which means more

jobs for American workers and this is another part of the effect of the program along with improving confidence by the consumer.

He seemed to feel this is something that would come on rather rapidly and help stimulate the economy. How about that?

Mr. NATHAN. I think it will come on. I don't have the optimism that he manifested in terms of the speed.

One of the things I am very enthusiastic about—the floating of the dollar and the adjustments in the rate of exchange which are bound to occur, but I must say, Mr. Chairman, I am much less enthusiastic about the 10-percent surcharge on dutiable imports. If there is any measure which could lead to retaliation it is the import surcharge tax and, second, it seems to me that with a 10-percent surcharge it is going to be much tougher for the dollar to find its relationship to other currencies that is rational and that is solid than without that 10-percent surcharge. I hope that 10 percent comes off quickly, and I hope we would have a bigger devaluation or revaluation.

Chairman PROXMIRE. Of course, that 10-percent surcharge is tied in with an investment credit which is only provided for purchases of American equipment.

Mr. NATHAN. Yes.

Chairman PROXMIRE. Once the 10-percent surcharge goes off I understand that exclusive buy-American part of the investment credits also comes off.

Mr. NATHAN. I still would prefer to see the 10-percent surcharge go off early and let the dollar move more. Maybe the dollar may have to devalue more, and other currencies may have to revalue more in order to get the impetus in exports that we need, but I think the combination of the floating of the dollar plus the surcharge is not very logical.

Chairman PROXMIRE. Congressman Brown.

Representative BROWN. It seems to me the surcharge is more apt to accomplish what the President said he wanted to accomplish and that was he wanted to get some attention from the people who had been trading in the United States and dumping products on U.S. products.

Mr. NATHAN. Oh, yes.

Representative BROWN. I cannot think a tariff war is going to be encouraged by any country that has 17 to 18 percent of its gross national product involved in foreign trade as the Japanese do, or as the Germans do, 20 to 25 percent of its gross national product involved in foreign trade. I just don't see them reacting to encourage an international trade war, do you?

Mr. NATHAN. Well, in the case of Japan, I have always felt if we went protectionist it is more their fault than anybody else's.

Representative BROWN. Right. And I can't see them reacting by encouraging a tariff war in the world.

Mr. NATHAN. No. But, on the other hand, Congressman Brown, we all know that the Japanese Government is not devoid of Government participation or interference beyond the degree we have here. A lot of people gripe about U.S. Government participation in economics.

Representative BROWN. Quite true and the instituting of this 10-percent surcharge is going to put all the cards on the table and we can discuss it on a man-to-man basis; isn't that correct?

Mr. NATHAN. Yes, but I am fearful that the yen will not change its value in relation to the dollar where it ought to, somewhere in the 15-percent range, if the 10-percent surcharge stays on. You may have to go through two floating periods; one maybe with the 10-percent surcharge on and that may be 5, 6, 7, 8 percent revaluation of the yen or devaluation of the dollar; and then when the surcharge goes off you may start that process all over again.

Representative BROWN. Well, perhaps the 10-percent surcharge won't go off as rapidly as we think.

Mr. NATHAN. Well, I would rather see it go off early and have the change in the rates of exchange be much larger.

Representative BROWN. Let me just go back to one other point that was mentioned in your colloquy with Senator Proxmire.

If we get a productivity increase and absorb that productivity increase in the lower cost of the American product, don't you think that will stimulate new jobs in this country because there will be an impact of stimulation of purchases of American products abroad or even the purchase of American products in America, because we are more competitive?

Mr. NATHAN. I think that improved productivity will be a positive factor in the expansion no matter how it works because it is going to give more real income to the workers and to the consumers.

Representative BROWN. Well, if you think of the United States encapsulated as part of the world with no foreign competition coming in, and to compete for products made in America or with no American trade going abroad to compete with foreign-made products abroad, then, of course, if you just gave the money back to the American worker why presumably he will spend more on American products. But unfortunately that is not the real world, is it?

Mr. NATHAN. Well, it is the real world in a sense that you have an interrelationship, Congressman Brown, that as you get more demand you also get more production.

You get more productivity.

One of the things, by the way, that I didn't emphasize this morning is that I would hope——

Representative BROWN. Wait, you are talking more about the domestic demand but are you talking about more world demand? Let me just say that one of the things the automobile producers and the automobile union, not union, but the automobile industry, could do was to carry on their contract negotiations, and so forth, for many years, and when they finally got through and had to raise the price of the automobile because of the wage increase that was won by the industry, they didn't have to worry too much about Americans buying competitive products; the consumer just paid the difference in the bill, right? But all of a sudden now you are getting foreign-made products which means foreign jobs, buying more or coming into this picture in the United States, Americans buying competitive products; there is competition in the world.

Mr. NATHAN. Oh, yes.

Representative BROWN. There is world competition in the U.S. auto market; is that correct?

Mr. NATHAN. No question about it.

Representative BROWN. Let me change the subject, but which goes on in the same vein, the administration's second inflation alert pointed

out that labor settlements which allowed some increase for productivity or the increase in wages because of productivity, plus cost of living increases are inherently inflationary. Would you agree with that?

Mr. NATHAN. Well, they are more inflationary, Congressman Brown, than without an escalator clause.

Representative BROWN. Wait a minute. If we absorb the productivity in a wage increase which has to be passed on across the product, and then allow an inflation increase in costs which maintains the inflationary level at its existing level, doesn't that tend to feed the fires of inflation and also with reference to the cost of American products in world competition maintain them at an artificially high level?

Mr. NATHAN. But there is an implication, though, Congressman Brown, in what you have said, namely, if you don't have the escalator provision and you don't get the raise in wages then you probably get a reduction in prices; and we have very little evidence that that happens.

You know, even in the times when we have had very low wage increases we see very, very seldom evidence of reduction in prices.

Representative BROWN. Are you talking about domestic prices or foreign competition?

Mr. NATHAN. No; I am talking about domestic prices which effect foreign competition.

Sure, I would love to see us have an absorption of productivity through lower prices rather than higher costs or higher wages all the time, but the problem is if you don't get it in higher wages you don't tend to get it in lower costs.

Representative BROWN. But you see in recent years we have not had that absorption of productivity in the wage costs, have we?

Mr. NATHAN. No; you have not.

Representative BROWN. In other words, the wage increase has absorbed both productivity increase and the cost-of-living escalator; is that correct?

Mr. NATHAN. The catchup.

Representative BROWN. Isn't that particularly true in the automobile industry?

Mr. NATHAN. It is true in most industries.

Representative BROWN. How are we ever going to get to the point where we can either maintain or lower prices which Senator Proxmire and you agreed was psychologically advantageous in our situation today if we don't either absorb some of the productivity increase or "eat" some of that wage increase, either labor or industry, and that is the objective of the President's program, everybody tighten their belts a little.

Mr. NATHAN. There is no doubt any antiinflation program, any stabilization program has elements of what you said in it, but the question I bring up is the one of equity—who is going to be certain that this burden is shared; and I think labor——

Representative BROWN. Isn't that the objective of freezing both wages and prices? I don't happen to agree with one of the predicates you laid down in your statement: that it is easier to control wages than it is to control prices. You can't control wages unless you freeze a guy in his job because a guy who wants to move from one job to another and increase his income can certainly do it; he is free to do it in this society of ours and should be.

But when you have a fixed price on a defined product that price is pretty clear. I think it is pretty easy to control those prices and I would hope the American people, the individual consumer, would make an effort to make that control work.

Mr. NATHAN. Well, when I said control wages, I am talking about wage rates and, sure, a man can always move. We have people moving out of our firm and people moving into our firm also. You have mobility in the American economy and it is desirable. But there is no doubt that wage rates are apparent to employers and they are aware of them; they are visible; and you have a more fungible unit in terms of a wage rate. Whereas in prices you have all kinds of variations; you have all kinds of extras and variations—in quality and quantity and discounts and things of that nature. And we found out during World War II and during Korea it is awfully, awfully tough to define prices.

Representative BROWN. Isn't this true with wage rates? When a man goes from one qualification to another, doesn't his wage rate change?

Mr. NATHAN. That is true from job to job but it is a different job. But the wage rate for a given job, a given employer, within a given plant doing a certain job is quite easily identified.

Representative BROWN. I would say so in my particular business because we have changed the whole function of our operation in printing from letterpress to offset.

How you define a comparison in jobs between that thing in a couple of years I don't know and that is one of the objectives we have during this period of time, during the investment tax credit to modernize their operations; isn't it?

Mr. NATHAN. It certainly is, in order to reduce costs.

Representative BROWN. I think it is very difficult, you know, to freeze those wages if you change plant investments.

Mr. NATHAN. Well, there are certainly exceptions and when you have a rapid rate of technological change the definition of a specific job is hard to stick with over any given time. But by and large we have found in actual practice that it is much easier to define and identify a wage rate than a price.

Representative BROWN. Well, we still disagree apparently on that subject.

I have no other questions, Mr. Chairman.

Chairman PROXMIRE. Mr. Nathan, I want to thank you very, very much for a fine job, most helpful and enlightening and responsive. We deeply appreciate your fine job.

Mr. NATHAN. Thank you.

(Testimony was then heard from Mr. Geoffrey Moore and other officials of the Bureau of Labor Statistics.[1] Following which, at 12:40 p.m., the committee was adjourned, to reconvene subject to the call of the Chair.)

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[1] The testimony of Mr. Moore and Mr. Goldstein is not printed in this volume but can be found in "Current Labor Market Developments," hearings before the Joint Economic Committee, April 2, May 7, June 4, July 2, August 6, and September 3, 1971.

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